REGULATORY AND TRADE DEVELOPMENTS

RISK AND RESPONSIBILITY IN FOREIGN INVESTMENT AND INTERNATIONAL TRADE

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Introduction

On September 10, 2001, there was no expectation of risk from terrorism in New York. On December 1, 2001, the day before Enron filed for bankruptcy, there was full confidence in U.S. corporate accounting. These are just two examples of how we are often blindsided by events. Risk assessment is about understanding the full range of hazards we face, their probability of occurrence and potential severity. Risk management is about selecting the level of resources to devote to reducing the probability and/or severity of such hazards.

Two factors, globalization and leaner government, are reshaping the landscape of risk management for firms. Globalization exposes firms to risks associated with operating in unfamiliar settings. Leaner government is often seen as a way to give firms greater freedom, but it also transfers risks that the government may have monitored and managed onto the shoulders of firms.

In general, being a risk taker or risk averse is a personal trait. It is a trait that evolves with age and experience and is often reflected in the manner in which firms operate. We generally take actions to identify and manage risks. Risk management activities are sometimes mandated by regulations and professional standards and at other times are a matter of personal choice.

This article first discusses the importance of risk management. Then follows a discussion of the grey area between risks, liability and the ethics of responsibility. The next section is devoted to a discussion of the shifting burden of risk management. Reactions to the proposed Global Compact and thoughts on why businesses need NGO and government partners to manage risks to society and environment are then offered. In response to these challenges, a two-step strategy to better manage risks faced by Canadian firms operating overseas is proposed.

Subjectivity, Uncertainty and Risk

Risk perceptions and management behaviour of firms and individuals are indistinguishable. Governments, when functional and through being the ultimate insurer, often fulfil a different role by setting the bright-line of what risks and risk levels are tolerable. However, with the advent of smaller government and globalization, their role is evolving rapidly. This issue will be returned to below.

There are two aspects to risk management, the decision-maker's attitude towards risk taking and the magnitude and probability of hazard. Beyond being a risk taker or risk averse, the decision-maker relies upon assessments of the factual aspects of the risks being faced. Uncertainty or error in the frequency or magnitude of a hazard can lead to poor decisions. Frequent events such as deaths and car accidents offer plenty of opportunity to develop an understanding of factors that lead to longer life and safer driving. This permits insurance companies to offer contracts that strike a balance between a decision-maker's risk and risk-mitigation comfort levels. For hazards of lesser frequency, the insurance company may offer contracts on catastrophic losses, but its ability to strike a balance between the cost of a contract and its redemption value is as hampered as other individuals' and firms'.[1]

Unfortunately, the subjective responses to risks and their nature are not independent. Where we have less personal experience with a particular hazard, we are routinely more risk averse.[2] This and other types of biases make risk management a difficult balancing act.

Managing Risk

The notion of managing risk arises from the recognition that we face many different risks and have limited resources to devote to their control or mitigation. With infinite resources for risk management we could have infinitesimal risks. With fewer resources, we should aim for the same bang for our buck across all risks.

Not all risk management measures are effective in reducing long-term risks. The commonest example, sometimes referred to as "moral hazard", is when obtaining insurance against a particular hazard leads to lessened precautionary measures to avoid it. Another example is where current risk mitigation leads to greater future risks. For example, building levees along rivers leads to protection against frequent flooding and the security required to enable investment in their vicinity. However, a levee designed to provide protection against 100-year floods will be breached by rarer, more severe floods. When this happens, not if it happens, greater damage will ensue because the levees were put there.

Careful risk management needs to take into account the long-term and repeated nature of hazards and human/organizational behaviour. Many risks are simply a facet of our inability to address more fundamental social tensions. For example, building in hazardous locations reflects lack of knowledge or the local government failing to balance the enthusiasm of developers with the welfare of the public and the environment.

From a governmental perspective, there are social, economic and environmental risks in need of management. Each of these is a resource, and their use poses risks. Ideally, governments create a milieu where individuals and

firms can thrive without harming one another, society or the environment, now or into the foreseeable future. They do so by offering institutions for addressing grievances and through setting and enforcing standards of practice aimed at assuring tolerable risks to society, the environment and the economy.

For a firm, there are three broad categories of risks: (a) betting on the wrong product, (b) using the wrong production process, and (c) operating in the wrong milieu. More specifically, a product can be a flop or it can cause unexpected harm to consumers. The management of such risks is made easier by being aware of their possibility and conducting market studies and prototyping to identify possible flaws and decide whether they can be remedied, whether the product should be withheld from the market, or whether funds should be set aside to compensate those harmed.

The parameters of the production process are tightly constrained by economics and regulations. Persistent asymmetry of information between firms and regulators does mean that regulations could be targeted on the "wrong" issue. If firms are found to have wilfully misguided regulators, there could be retroactive culpability and even greater regulatory risks for firms. It is important to note that even when firms comply with local regulations, they could be exposed to the risks of not meeting higher standards set by overseas customers. Even though the WTO expressly forbids differentiation of products by their production process, consumers have the ultimate power in the market place and their opinions and preferences can be shaped by external interventions such as advertising and information campaigns. Management of such risks rests on a cooperative relationship with governing institutions and stakeholders.

The milieu in which a firm operates is much more than local regulations. Firms operate in an environment of goodwill (or at least acquiescence) of the local population. Governments can be neglectful, uninvolved or constructive on this issue. Grievances against the state are not limited to dictatorships. Where the public perceives inequity in justice and power, there is deep-rooted tension between the state and its subjects ready to erupt when agitated. In many countries this has led to the close association of foreign corporations with specific governments and the two being evicted at the same time. It is essential to note that while many aggrieved parties may not be strong enough to overthrow governments, they are usually more than strong enough to disrupt the operation of firms.

The most difficult risks to manage are those that are socio-political in nature. Inept government goes hand in hand with unpredictable institutions. The absence of predictable institutions leads to mismanaged expectations and obstacles to addressing grievances. These in themselves create a disillusioned and dysfunctional social and economic environment. Mismanaged expectations create the greatest risk of broad social upheavals and unstable operational environments. Firms facing such circumstances tend to fall into two categories, those who pull up stakes and leave and those who try to assure their own survival by offering generous gifts to high government officials. A third way is also possible, that of growing deeper roots in the local community and establishing a distinct identity.

Canada enjoys unparalleled goodwill internationally. It is often seen as a voice of reason and respect. The Canadian government and firms can forge a higher road of social responsibility to build on these strong foundations.

More specifically, Canadian firms could be mandated to participate in local development projects in exchange for corporate tax breaks at home. Canadian firms could also be mandated to publish the specifics of their operational expenses overseas to their shareholders, and to work towards local ownership of their assets over a given time horizon. This would establish Canadian firms as partners in local development. The Canadian government would advertise these operational strictures overseas and make the public aware of their implications. Under these circumstances, local government officials would see more than simple personal remuneration through gifts for granting operating permits to Canadian firms, they would also win public support for being wise in who they choose to allow to operate in their country.

Between Risk Management and the Ethics of Responsibility

As domestic standards for safety and environmental protection grow more stringent, many firms have opted to move their production facilities overseas. In doing so, they are seeking lower operating costs and less stringent environmental regulations. This will inevitably lead to compounded risks in the future. With greater access to information, activists can broadcast evidence of poor corporate citizenship and environmental degradation overseas. This taints brands and embarrasses firms and undermines their economic stability. Firms shown to operate at lower standards overseas than in Canada face a mounting probability of ejection as the region develops.

A *"Higher Standard of Care"* is proposed as another aspect of the operational paradigm of Canadian firms establishing their bona fides beyond their competitors. For example, a mining company may limit its risk management to its liability relating to workplace safety and environmental controls. However, that is not all that a mining company brings to its local environment – it brings wages too. What the workers do with their wages is not part of the firm's sphere of liability, but taking care to limit harm from how this new-found wealth is spent can ensure local well-being and the firm's longer term prosperity.

Global Change and Risk Management

There are a number of global change processes which have caused the pace of change to outstrip our capacity to identify and manage risks. Rapid technical change, globalization, the paradigm of small government and reliance on market forces have all changed the landscape of economic, social and environmental risks. Unfortunately, we only realize the magnitude and nature of these risks after we have suffered their consequences.

In an era of rapid technological change, we face the possibility of new hazards and our ability to identify them before experiencing them is often limited at best.[3] Globalization has been shifting the locus of manufacturing offshore. At the same time, governmental oversight of firms has been weakening. This has shifted the burden of risk management onto foreign governments, multinational corporations, and NGOs. The human resources necessary to identify, monitor and manage risks from manufacturing in less industrialised countries have been severely outstripped by the rapid appearance of myriad manufacturing plants and processes on their shores. In addition to a diminished oversight and enforcement role for governments, another significant change over the past two decades has been the gradual liberalization of markets and deregulation of commercial activities. These changes contributed to the increased and sustained economic growth realized at the end of the twentieth century.

The rapid growth of NGOs over the past two decades has been fuelled by the inadequacy of government oversight efforts to protect public and environmental welfare. Firms cannot be asked to self-impose an appropriate standard of care. When governments fail to step in with credible measures to manage risks to society and the environment they lose public trust.

Relocation of industry offshore to escape regulation may be a current boon to firms seeking lower-cost operating environments. However, local human resource constraints are increasingly offset by globally active NGOs. They are able to collect and disseminate information about questionable practices, shaming governments and corporations and tainting the latter's brand image and economic prospects.

To deal with these issues of global change and risk management, a code of conduct is proposed that would mirror the best practices of Canadian firms in both their domestic and overseas operations. Government can take an active role in this effort by supporting and coordinating efforts to identify best practices internationally. It can also help propagate information about these through training courses and workshops aimed at enhancing the human resources of nations hosting Canadian firms. A "*Network For Best Practice*" will assure awareness of trends in risk assessment and management faced by Canadian firms operating amidst a number of evolving regulatory frameworks abroad.

The Global Compact and Other Initiatives

The Global Compact, first proposed by United Nations Secretary-General Kofi Annan in January 1999 (see www.unglobalcompact.org), is perhaps the best-known official effort to sensitize businesses to their responsibilities in the areas of human rights, labour and the environment. The nine principles of the Global Compact, reproduced below, place the onus of activity on businesses and business leaders.

The Nine Principles of the Global Compact	
Human Rights	
Principle 1:	Businesses should support and respect the protection of internationally proclaimed human rights within their sphere of influence; and
Principle 2:	make sure that they are not complicit in human rights abuses.
Labour Standards	
Principle 3:	Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
Principle 4:	the elimination of all forms of forced and compulsory labour;
Principle 5:	the effective abolition of child labour; and
Principle 6:	eliminate discrimination in respect of employment and occupation.

Environment

Principle 7:	Businesses should support a precautionary approach to environmental challenges;
Principle 8:	undertake initiatives to promote greater environmental responsibility; and
Principle 9:	encourage the development and diffusion of environmentally friendly technologies.

The likelihood of this appeal bearing fruit is questionable. The role of government in collective risk management cannot be devolved to firms. Firms are profit driven and even when willing to shoulder more responsibility, they are unable to articulate the full range of interests that need to be considered. Inclusion of NGOs does not solve the problem either. NGOs pursue particular interests and not all interests have come to be the focus of an NGO's efforts. The business of NGOs demands that they adopt causes that have sufficient public support to ensure their own survival. Only governments can legitimately adopt the mantle of balancing the multitude of competing interests. Furthermore, the burden of policing firms cannot be left to NGOs. Firms and NGOs could each excel in managing risks of importance to themselves, but are unlikely to strike the balance that serves the collective good. For example, while firms could be overly optimistic about the risks posed by a new technology, NGOs could overstate the risks in order to assure their own importance and visibility. Government cannot sit on the sidelines and hope for the best interests of citizens to emerge from the struggle between firms and NGOs.

Conclusions

Risk assessment and management have subjective and objective dimensions. Even where objective uncertainties about the nature of some risks can be resolved, risk management should reflect the subjective concerns of all interested parties. Subjective perceptions of risk are influenced by a multitude of personal and environmental factors and they evolve over time. Being a risk taker or risk averse shapes the extent to which risks are tolerated versus the measures taken to limit them. Knowledge of specific risks and subjective responses to them are not independent. We tend to dread risks that are new more than those that are known to us through experience.

Better risk management demands recognition of some foibles of human and organizational behaviour. These lead some risk reduction strategies to have the opposite outcome. For example, buying insurance against a risk may lead the insured to be less vigilant about such risk. It is hard for us to recognize such situations. However, it is far better to learn how to recognize activities that are inherently risky and curtail them early on than it is to develop a growing dependence on such activities through adoption of increasingly costly risk reduction measures.

A combination of global change processes has led to risks that often outstrip our capacity to assess and manage them appropriately. In a systematic sense, the prevailing political philosophy has led many governments to cede their role in managing the risks faced by the public and the environment to NGOs and firms. Neither of these parties has the breadth of vision to carry this burden. Shifting manufacturing to developing countries has outstripped their capacity to assess, monitor and manage risks. Rapidly changing technology has also introduced potential hazards that have yet to be assessed and understood.

The greatest risk faced by any firm is losing public trust and support. A primary aim of risk management for firms active overseas should be to strengthen public trust. Such a strategy builds on the high status of Canada internationally and sets new standards for corporate citizenship. What is proposed is a partnership between the Canadian government and firms active overseas that defines and supports a *Higher Standard of Care* and establishes a *Network for Best Practice*. A *Higher Standard of Care* will allow Canadian firms to step beyond managing their direct liability and assume leadership where no others are presently engaged in protecting social and environmental welfare. A *Network for Best Practice* will assure that Canadian firms are not only working in accordance with the highest standards worldwide, they are actively shaping and disseminating information about such practice.

Notes

[1] Reinsurance and other vehicles are used to spread the risks from more uncertain risks, but in reality the payoffs for catastrophic losses are often siphoned from the much larger pool of actuarial risk premia. Were an insurance company to offer coverage for extreme events that are larger than a small fraction of its actuarial contracts, its very survival would be in question.

[2] For example, in 1986 the threat of terrorism in Europe meant that 25% of North American holiday makers took to the road instead of flying to Europe. These tourists had weighed their options. On the one hand, they could fly to Europe and face the risk of an unfamiliar but dreaded situation of a terrorist attack. On the other hand, they could stay in North America and enjoy a driving holiday. Their exaggerated aversion to risk from terrorist acts led to significantly more road-deaths in North America.

[3] For example, we designed CFCs to be inert chemicals capable of replacing ammonia in refrigeration units. Their adoption reduced the risk of being poisoned by ammonia leaks, but we did not even conceive of how and where a relatively inert gas would decompose in the atmosphere and how that process might harm the ozone layer. This is but one example of how attempts to address one risk can lead to the creation of new risks.