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ETHICS, SOCIAL RESPONSIBILITY AND CORRUPTION AS RISK FACTORS

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Abstract

The financial risk characterises the variability of net profit, subject to the financial structure of the insurance. The capital of the insurance company has two elements (the equity and the borrowed one) that differ fundamentally in the cost they generate. If the company uses loans, it will bear systematically the related financial expenses, too. Through its size and cost, indebtedness leads to the variation and changes the size of financial risk. Resorting to the debt is justified through the high remuneration of equity in relation to borrowed capital, thus increasing the financial return.

Keywords: *economic risk; financial risk; bankruptcy; institutional motivation; macro-risks.*

JEL Classification: A_{20}, M_{16}, O_{39}

Introduction

The economic risk is the sensitivity of the gross profit and can be analyzed from two different points of view: in terms of the insurance company that aims to increase patrimony and profit-equity for investors' remuneration as well as from the point of view of the investors seeking optimal placement of capital depending on the opportunities offered by the insurance market.

Gross profit is determined based on the turnover as an indicator of measuring the insurance activity characterized by a volume of the variable costs, of the fixed costs, including depreciation, and through a certain threshold of profitability.

The financial risk characterises the variability of the net profit, subject to the financial structure of the insurance company. The capital of the insurance company has two elements (own and borrowed capital) that differ fundamentally in terms of the cost they generate. If the company uses loans, it will systematically bear the related financial expenses, too. Through its size and cost, indebtedness leads to the variability of the results and changes the size of the financial risk. Resorting to indebtedness is justified by the superior remuneration of the own capital compared to the borrowed capital, thus leading to the increase of the financial profitability. Through indebtedness occurs an increase of the financial risk determining the shareholders to demand a higher financial profitability to cover the increased risk. Thus, increasing profitability and minimizing the cost of capital require the society to determine an optimal structure of its capitals. This proves that the financial risk is generated by the financing policy of any society.

Bankruptcy risk analysis can be performed in static manner by analyzing the financial balances in the balance sheet or dynamically by analyzing the flows contained in the financing picture. Regardless of the method of analysis, the diagnosis of bankruptcy risk implies assessing the ability of the enterprise to meet its commitments to third parties, thus assessing the solvency of the enterprise.

The functional static bankruptcy risk analysis uses as operational tools the need for working capital for exploitation and the net treasury, the state of insolvency being reflected by the way in which the functional financial balance is achieved.

Patrimonial static analysis of the bankruptcy risk uses the net patrimony of the shareholders and the economic asset as a whole, as a guarantee for the creditors. The instruments used for this purpose are the financial working capital and the liquidity rates supplemented with the indebtedness rates. If the company's financial difficulties become regular, they can endanger the fundamental balances and affect the company's reputation, categorizing it as "bad payer", image that unfavourably influences its future work.

The dynamic analysis of the bankruptcy risk, performed inside the financing picture, starts from the flows of funds determined by the exploitation operations as well as by the capital and explains the financial imbalance evidenced by static analysis.

Ethics and social responsibility have become a sensitive issue, especially in economically developed countries. Underestimating this phenomenon, called reputational risk, can lead to loss of customers, to the reduction of the operational activity volume, and to difficulties in attracting new customers. The consequences of these situations are implicit for business: reduced profitability, reduced growth prospects, a significant decrease in the market value of the company.

One of the consequence of economic integration, globalization, is a greater risk of being the target of a process of money "laundering". The rivalry between economic and financial actors, the areas free of restrictions and rules of law, the

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expanding of the means of communication, the dematerialization of the financial flows, the technical facilities for transferring funds are elements that favour the "laundering" of the criminal money.

The ethical character of the struggle against money "laundering" should not be underestimated. The volume of "laundered" money each year is considerable. The method used, otherwise quite unreliable, in determining the volume of "bleached" cash flows consists in *comparing the volume of expenditure officially registered in a country with the volume of the amounts officially received by the same country.* There is a deficit that can be explained only by "black money". "Off-shore" countries, also called tax havens, are the main vectors for the flow of "black money", given the quasi-inexistence of taxation, the absolute banking and business secrets, the total absence of control over transactions, over the origin of funds or over the business activity.

But what are the resorts of ethics in business in particular or those of ethics in society, generally speaking? Each of us, as social actors, has its own system of beliefs and values that reflects their own social and cultural environment as a result of adapting to the problems and difficulties from the external environment and the integration of religious norms.

Here are some figures that reveal the extent of the phenomenon: the US drug market represents between 100 and 300 billion dollars annually; the volume of money being washed worldwide amounts to about 3-5% of the world's gross product or from 600 billion to 1.5 trillion. Moreover, some analysts believe that religion is the most ambiguous socio-cultural aspect, commonly used as a pretext for triggering and supporting the terrorist acts and the war, both extremely dangerous and risky, not only for the business environment but also for the human society.

The responsibility of social actors is the result of the power relations between them and of the existing institutional environment, in particular of its structure and functionality. Freedom of decision is the essential component of morality and is, from an ethical point of view, more relevant than any other criterion. That is why the democratic system and the free market mechanism offers the possibility of solving the conflict of interests between social actors in a much fairer way than the system based on oppression and domination of others – the right environment, moreover, for amplify corruption and opportunism.

Corruption is a risk with direct implications, regarding the reputation, but also indirect implications, regarding the market, for the business world. The list of countries politically and economically destabilized because of corruption is quite long. The slow reform from the Central and Eastern European countries is largely the result of this phenomenon. The exercise of discretionary power and, the often, monopolistic market position of the public enterprises are the premises of corruption. The convergence of the political, bureaucratic and economic interests forms the environment conducive to the development of corruption. Reality proves that the phenomenon can occur at all levels, from high-level corruption (senior officials in the political power hierarchy) to petty corruption (civil servants at the core of the public organizational system), with different implications, undoubtedly, for the society and for the environment business.

Corruption involves a tacit agreement between companies, pressure groups and citizens who are trying to maximize their own interests by paying bribes, on the one hand, and the public bodies (their officials) and politicians that tend to maximize their income by illegal means, making use, for the personal purpose, of the power they have, through the nature of the position they hold, on the other hand.

Political analysts and sociologists consider that the civil society would have had a greater control over the political power if the phenomenon of corruption would not have had the magnitude of today. But, nevertheless, morally speaking, the democratic system and the free market mechanism are superior to the centralized or state system, concerned only with its own interests, because there is not and/or does not function an institutional mechanism that should sanction these behaviours, the confidence and the social stability being severely affected.

The conclusions of some studies reveal significant differences between developed and developing countries, in terms of the magnitude of corruption. Of course that the phenomenon exists in developed countries as well, but their institutional environment did not allow the transformation of corruption in a systematic phenomenon. In the case of the developing countries, where the institutional environment is non-functional or nonexistent (ownership is undergoing (re)establishment, leaving room for many abuses), corruption has become an endemic phenomenon, favouring the clientelism, incompetence and inefficiency, feeding underground economy, incites to tax fraud, distorts programs that combat poverty and undermines international programs that support the economic reconstruction.

Although the cost of corruption is difficult to assess, however, some effects are of indisputable evidence. Corruption, as a phenomenon, reduces the volume of investments in the economy, threatens the economic growth, leads to increasing taxes and duties, and influences the allocation of public funds (favouring projects or programs that allow the collection of some substantial illegal incomes, hence the proliferation of some unnecessary and ineffective projects).

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The phenomenon, globally speaking, can be described in a suggestive manner, using the concept of market structure and taking into consideration the two parties involved: "the carriers of the demand" – public entities or their representatives – and "the carriers of the offer" – private entities.

The situation of bilateral monopoly occurs when the balance of power is relatively balanced between the public and private sectors, and political and economic elites are reduced in number and relatively homogeneous. The situation is typical for the Western Europe and the United States. The institutional environment and the democratic system allow voters to punish those involved in corruption.

If the *demand* dominates the *offer* we deal with the phenomenon of "kleptocracy" characteristic for the developing countries, where the civil society and the private sector are underdeveloped, human rights and property rights are nonexistent or under (re)establishment, the political power is fragmented (often between regions, ethnic groups or factions belonging to the same political party). In this case, the beneficiaries are those who set the "transaction" price, using various means to this end: violence and intimidation. This situation leads to negative consequences. The over-exploitation of the raw materials, hijacking or non-use of international financial funds, degradation of the social system, of the social cohesion, which are typical for a system with an endemic corruption.

The second case, when the "offer" dominates the "demand" is typical in cases where the state is intimidated by criminal organizations who seek to exercise their power over it through violence. Sometimes, the *demand* and *offer* are fragmented, situation that corresponds to a relative atomicity, which generates competition between corrupters.

Political risk is defined as an adverse consequence resulting from the political events. However, a definition of political risk focused only on the negative consequences is inadequate to determine the impact on the cost of capital. If the political risk is diversifiable, than it does not affect the investor's gain or the capital cost of the company, although it may affect the company's cash flow.

If a particular political risk is diversifiable or not, this depends on the relevant market portfolio against which the systemic risk is measured. The results depend on the extent of the integration or segmentation of the local capital market compared to the global one.

When the stock market is integrated, the relevant market portfolio is the market portfolio of the global market. When the domestic market is segmented, the relevant market portfolio is the internal market portfolio. The empirical evidence suggests that the real world of the capital market ranges from perfect integration and complete segmentation. Given the specific variation of the countries regarding the degree of segmentation of the capital market, choosing the market portfolio against which the diversifiability or the non-diversifiability of the political risk sources will be measured must be made from a case to another.

Governments impose restrictions when the market conditions deteriorate, which may be relaxed when local conditions improve. The influence of the political risk sources on the cost of capital that depends on the degree of correlation of the consequences of such events to the gain of the relevant market portfolio.

In all charts and international rankings, Romania takes high marks for corruption and opacity. Broadly, the term of opacity includes all underground economies: black money, money laundering, black holes, hostility of the business environment. Opacity index, as an average of the coefficients associated to the CLEAR (Corruption, Legal, Economic, Accounting, Regulatory) acronym, reveals the economic, political, administrative and cultural causes of the lack of transparency and refers explicitly to the corruption of the governmental structures, the laws regarding the property and agreements, economic policies, especially the monetary and fiscal ones, accounting and auditing standards, as well as the regulation of business environment. In other words, *high risk*.

1. **Locating Investment and Political Risk**

The strategic investment decision of the multinational companies (MNCs) is built on two coordinates:

– "institutional motivation" behavioural type that assesses the potential implantation environments from the economic point of view;

– "international location" spatial type that assesses the potential implantation environments from the political and institutional point of view.

The decision to invest should be taken by balancing the balance between capitalizing on the winning opportunities through foreign direct investment (FDI), on the one hand, and the possibility that the political factors from the implantation space may cause undesirable interferences in the unfolding of specific investment operations, on the other hand.

Throughout history, the state has had the role of maintaining order and reducing business uncertainty, but as time passes, it not only fails to provide security, but is itself a source of uncertainty. Therefore, political risk is a major problem for companies acting through investment in the international environment.

The term of *political risk* has not been universally defined and accepted because of its complexity, being determined by a multitude of variable factors, some of them in interdependent relationships, more or less controlled by the host country and more difficult to position and evaluated by the MNCs. Clark E. defines the political risk as "the events of macroeconomic, social, political nature or the strategic factors specific to the host country that may affect the company's interests".

In the conventional approach, the political risk is considered as arising from the conflicts between the MNCs and the governments in host countries related to the aims and objectives pursued by each of them. The economic basis of the conflict is represented by the resource allocation control by the MNCs and the distribution of earnings from the company's operations in the host country.

Theoretician Stephen Kobrin, considered authority in the field, says that the political risk is classified according to two dimensions:

– first dimension distinguishes between the risk specific to the host country (the political macro-risk) that affects all foreign companies operating in the host country, regardless of the field of activity, and the risk specific to the investing company (the political micro-risk), manifested at an industry, company or investment project level.

The risk specific to the host country, also known as country risk, is of particular interest to international banks and the risk specific to investing firm matters to the MNCs;

– the second dimension distinguishes between the political events affecting ownership of assets and those that affect the operations of the company.

Changes induced by political events involve a number of restrictions with respect to freedom of price fixing, freedom on the use of expatriate managers or workers, as well as regulations on locally processed products.

Conflicts between the objectives of the MNCs and those of the host-governments are generated by problems such as the impact of MNCs' activity on the economic development of the host country, the interference of MNCs on national sovereignty, the foreign control over key national industry, sharing ownership and control of assets with local business groups, the impact on the balance of payments from the implementation country, influencing the exchange rate of the national currency from the host country, control over export markets, using foreign managers and workers at the expense of the domestic ones, exploitation of the natural resources of the host country. So looking at things, it appears that for MNCs the government's economic, political, social, cultural and ideological targets, as well as the instruments to realize these are parameters that circumscribe the investment activities. Sometimes, the governmental policies are ambiguous or even contradictory. Therefore, MNCs must anticipate the changing national priorities.

As a conclusion, it can be noted that the conventional view of the political risk, of a conflicting nature between the objectives pursued in good faith by MNCs and the host governments, has unintentional character, being a problem of passive assumption and adaptive reaction to the reality of the friction state. This implies the correct assessment and measurement of the political risk and the location decision must be taken, either by assuming the political risk, or by taking measures to counteract or reduce it.

2. **The risk in international businesses**

The internationalization of businesses, as a particular form of the economic activity, is a complex and lengthy process, employing significant financial, material and human material. Conducting businesses on foreign markets will be achieved only if there is a strong enough incentive, able to motivate companies to take the implied risks and needs to include the concepts of risk and uncertainty in the structure of the decision-making process.

International risk can be regarded as the exposure to the total or partial loss of the capital invested in businesses located in different foreign markets. These potential losses are caused by specific events that can be known in a lesser or greater extent by the capital owner or the manager (administrator) of that business.

The risks faced by a company operating business on international markets can be classified according to several criteria: the degree of assumption, their amplitude and probability of occurrence, the degree of diversification, the nature of these risks etc.

A. *Assumed risks and excluded hazards.* Of all the international risks, most fall into the category of identified risks (the company can identify with a certain precision the risk factors and the effects of their materialization), but the company will assume only some of them, namely the major ones (capable to cause substantial losses). Thus it remains a category of identified risks, which the company will voluntarily exclude (minor risks) and a category of risks involuntarily excluded because they cannot be identified. The difference between major and minor risks is given by the magnitude of the loss that may be caused both by their materialization and their likelihood of occurrence.

B. *Macro-risks and micro-risks.* The risks that a company that invests abroad is facing are classified, depending on the perspective from which they are addressed, in macro-risks and micro-risks. The macro-risks are the result of the evolution in a certain sense of the business environment conditions where the investment is located. In the category of micro-risks fall all environmental risks such as the country risk, the transfer risk, the sovereign risk, the political risk, the market risk etc. Micro-risks are determined by endogenous factors, specific to the field of activity, to the company and to the project itself and/or by the insufficient correlation between the specific features and the limits imposed by the general framework of the host country. In the category of micro-risks fall most of the company risks and project risks: the risk of implantation, the currency risk, the interest rate risk, the price risk, the commercial risks, the staff related risks, the legal risks, etc.

C. *Systematic and unsystematic risks*. From another perspective, transnational companies face mainly two types of major risks: systematic risks (non-diversifiable) and unsystematic risks (diversifiable). The difference between the two is given by the factors underlying their production. The systematic risk depends on the general economic factors (such as inflation or political unrest), which determine the economic situation of the host country, while the unsystematic risk is determined by those risk factors that directly depend on the company's internal conditions. The investor can minimize the unsystematic risks by adopting some measures capable of improving the current situation of the company. Regarding the systematic risks, the investor accepts the possibility of their materialization without having too many minimizing means within ones grasp (generally, it is believed that companies cannot significantly influence the economic situation of the host country). In this case, it is more important the analysis of the systematic risks, because a smart investor can eliminate through its decisions the unsystematic risks.

The main risks encountered in international businesses. Another criterion for classifying the risks in international businesses has in view their specific nature. Looking from this perspective we can make a systematization of those on several types of risks: environmental risks, financial risks, commercial risks, legal risks, risks of implantation (or operational), etc.

D. *Environmental risks*. These risks derive from the quality of the overall business environment from a country. The frequent change of the policies promoted by the government of the host country, the takeover of power by nationalist or extremist parties, the establishment of some political or military dictatorships, the proliferation of corruption, profound economic crises, reducing the popular support for power, the change in the attitudes of the masses towards foreign investors and their activity, the lack of promoting an appropriate institutional and legal framework are just some of the major events that may implicitly lead to the worsening of the business environment from a country and that could cause significant losses to the foreigners who intend to perform or develop activities on that external market. The main environmental risks are: the country risk with its two components: the political risk and the economic risk, the sovereign risk and the transfer risk.

The country risk is often assimilated by some economists with the political risk, which is actually its main manifestation form. The evaluation of this risk is a fundamental stage in the decision-making process of the company's internationalization. The country risk is generated by the combined action of a varied number of factors of economic, political or social nature, whose subsequent development the company must consider. The probability that the country risk would materialize depends both on the occurrence of some events capable of causing losses (strikes, social convulsions, civil wars, changes of government, policy changes, natural disasters provided that they do not occur regularly, economic recession) and on the specific conditions of the surveyed country. The internationalization of the businesses is a complex process usually available to powerful businesses (transnational, multinational or global), which have managed to accumulate sufficient resources in order to cope with the demands of the international market. Market and product experience are also crucial in deciding the internationalization. This decision is a strategic one, aimed at a longer time horizon and the country risk has a central role in substantiating the decision to internationalize.

Between the country risk and the degree of internationalization on a market of the foreign companies there is a relationship of inverse proportionality. We can thus appreciate that the commercial operations (direct export, indirect export, licensing, etc.) represent the shape with the lowest degree of internationalization which is practiced when the country risk is very high. At the opposite pole are the foreign direct investments (in marketing or production) and mixed capital companies, complex forms of internationalization involving high value of invested capital.

In the decision-making process of internationalization, the evaluation of the country risk is not limited to an analysis of the "GO-NOT GO" type (enter this market or not). The analysis of the country risk goes further, offering foreign companies the possibility of choosing from the many forms of market penetration that form of internationalization appropriate to the level of risk and that leads best to achieving the goals. Also, depending on the risk level of the extern market, companies will be able to substantiate their response to the further deterioration of the environmental conditions that may affect the investment (for example,

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companies reduce their involvement on a foreign market – disinvestment as a response to a strong economic recession).

Concerning the capacity (speed) of response to the change in the risk level, this is determined more by internal causes:

– how to understand country risk and its implications for the international operations;

– by the attitude towards risk;

– by managers' ability;

– by the organizational structure;

– by the speed of data collection, handling and processing.

Consolidating the decision of internationalization without considering the risk involved leads to the wrong design and size of the business. It is undeniable the importance of the country risk analysis (part of the overall risk of the international business) in selecting the foreign market and the appropriate form of internationalization, as well as in the further adaptation of the investment to the environmental conditions. The quality of the decision is improved if the country risk analysis is correlated with other aspects of the internationalization process, so that the decision-maker to have an image as correct and complete as possible of the environment of action.

In developing a risk strategy, companies must take into account that:

– are "guests" in a completely foreign environment (often hostile) and must act as such;

– the earnings obtained do not belong exclusively to the foreign company, from the investment must as well benefit greatly the employees (typically local) and the economy of the host country;

– the investment risk reduces substantially by carrying out some initial training programs for managers (and their families) for a good knowledge of the foreign environment in which they will work;

– can easily penetrate the market if they engage in a series of economic and cultural projects of public interest;

– it is less risky to lead the foreign investment with the help of a management team in which local managers could eventually be attracted as well (the managers from the mother country supervising the operations performed), than to be led directly from the mother country.

The difference between country risk and sovereign (sovereignty) risk is given by their sphere of coverage. Operations such as the implantation of a company abroad or loans from various financial institutions to some companies from a foreign country are subject of the country risk. The sovereign risk concerns only the loans granted by the banks to some foreign governments, loans that make up the foreign debt of that country; this type of risk arises from the possibility that at some point the government of the debtor country cannot or does not want to repay the external debt. As forms of materialization of this risk, there is the risk of rescheduling, of renegotiation or repudiation of the external debt, which occurs the moment a country refuses to pay the debt or is unable to pay due to the worsening of its economic situation.

The transfer risk is somewhat similar to the sovereign risk and it takes into account cash flows arising from investing abroad. The risk occurs when an investment project makes a profit in local currency and the mother company wants to convert it into foreign currency and transfer it abroad. To discourage the outflow of funds outside the country, the state can refuse or delay the foreign exchange. In some cases, the refusal of the authorities to allow currency exchange is based on the lack of some sufficient currency funds to honour these requests. Thus, foreign companies are "pushed" to unwillingly reinvest the obtained profits into the economy of the host country or are forced to find other forms of recovering the profits. Since these profits are included in the balance sheet of the mother company, sometimes this risk is dealt with within the financial risk together with the currency risk or the interest rate risk.

Conclusions

We conclude that making the decision to internationalize, without taking into consideration the risk involved, leads to the wrong designing and dimensioning of the business and the quality of the decision is improved if the country risk analysis is correlated with other aspects of the process of internationalization as well, so that the decision-makers would benefit of an as accurate and complete image as possible of the action environment.

With regard to the sovereign risk, it only deals with loans granted by banks to foreign governments, loans that make up the foreign debt of that country.

This type of risk, meaning the sovereign risk, arises from the possibility that, at some point, the government of the debtor country cannot or does not want to repay the external debt, and the influence of the sources of the political risk on the cost of capital depends on the degree of correlation between the consequences of such events and the gain of the relevant market portfolio.

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