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Disaster Risk Reduction 2013

The EIU Methodology

EIU (Economist Intelligence Unit)

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OVERVIEW

The operational risk model provides a standard framework for the analysis provided on Risk Briefing, a service designed by the Economist Intelligence Unit to help executives manage international business risks. It quantifies the risks to business profitability in each of the countries covered by the service. In these assessments the Economist Intelligence Unit takes into account present conditions and our expectations for the coming two years.

Twenty-four additional indices, in which indicators are weighted to reflect the concerns of a range of investors covering seven industrial sectors, provide more targeted risk assessments.

STRUCTURE OF THE MODEL

The operational risk model considers ten separate risk criteria:

- security
- political stability
- government effectiveness
- the legal and regulatory environment
- macroeconomic risks
- foreign trade and payments issues
- labour markets
- financial risks
- tax policy
- the standard of local infrastructure

In considering each of these criteria, we examine a number of indicators. There are 66 in all, but the number of risk indicators in each category ranges from four (tax policy) to ten (legal and regulatory). The Economist Intelligence Unit assesses each of the 66 indicators over a forecast horizon of two-calendar years.

MEASUREMENT

We assess the ten criteria on a scale of 0-100, with 0 indicating very little risk to business profitability and 100 indicating very high risk. Each of the 66 indicators within the main criteria is scored on a scale from 0 (very little risk) to 4 (very high risk). Each indicator is given the same weight within its category in the standard scores, and the overall assessment is a simple average of the scores for the ten categories. In addition, separate ratings are available for 24 sub-sectors from seven industries, in which the weightings and overall assessment are adjusted to reflect the particular concerns of that sub-sector.

None of the 180 countries assessed earns a score of 0 or 100. This reflects the fact that risks are present even in the least risky countries and that even at the other end of the scale the risks could yet increase.

QUANTITATIVE VERSUS QUALITATIVE FACTORS

As the product looks forward and as we forecast future risk rather than simply extrapolate present trends into the future, qualitative indicators (e.g. the risk that capital controls will be applied in time of crisis), rather than quantitative, dominate the model. Even so, almost half of the indicators are based on quantitative data (e.g. crime statistics), and are mostly drawn from recognised national and international statistical sources. The comparability of the qualitative assessments is made more rigorous by the extensive guidance provided to analysts on each indicator, the ability of analysts constantly to view the scoring for other countries and oversight by the Risk Briefing regional heads.

RESOURCES

Ultimately, the ratings and scores for the operational risk model are driven by the expert opinion of our analysts working in regional teams. These analysts have a wide range of open and closed sources at their disposal. One of the main closed sources is our network of in-country experts who provide detailed, regular information on conditions within a country. The business operating risk model also draws on the existing analytic work already developed at the Economist Intelligence Unit through its Country Risk Model (available through the Country Risk Service) and business environment rankings model (available through the Country Forecasts).

The use of open sources is extensive and includes country-specific sources such as central bank reports, statistical yearbooks and country websites. International open sources include publications from the UN, CIA, IMF, World Bank, Heritage Foundation, International Institute for Management Development, International Labour Organisation, US Social Security Administration, World Economic Forum, Interpol and the US Commerce Department.

DESCRIPTION OF THE RISK BRIEFING CATEGORIES

This section outlines briefly what each risk category addresses:

Security risk - is the physical environment sufficiently secure?

Political stability risk - what is the degree to which political institutions are sufficiently stable to support the needs of businesses and investors?

Government effectiveness risk - does the political culture foster the ability of business to operate effectively?

Legal & regulatory risk – what is the risk that the legal system will fail to safeguard investment?

Macroeconomic risk - is the economy stable and predictable?

Foreign trade & payments risk - what are the risks to getting inputs/money into or out of country?

Financial risk – to what extent do financial markets provide adequate support and what is the risk that financial instability could disrupt business operations?

Tax policy risk - are taxes low, predictable and transparent?

Labour market risk – to what degree are labour market factors likely to disrupt business operations?

Infrastructure risk – what is the risk that infrastructure deficiencies will cause a loss of income?

RISK SCENARIOS

For 120 of the 180 countries covered by Risk Briefing, the operational risk scores and ratings are supplemented by brief articles pinpointing the most important threats to business operations. There are at least two and as many as four risk scenarios for each of the ten risk categories covered by the service.

Risk Briefing's risk scenarios describe potential developments that might substantially change the business operating environment over the coming two years. The items analyse the drivers and inhibitors, provide the context and potential timing of events and occasionally conclude with recommended action.

Scenarios are evaluated according to the probability of their occurrence and the potential impact on business profitability should they occur. Probability and impact judgements are made on a five-point scale. The product of these two indicators, in a range of 1 to 25, is presented as a scenario's risk intensity score. Scenarios are presented in a country watchlist, headed with a table that can be ranked by impact, probability and intensity, and by risk category.

INDUSTRY RISK INDICES

The operational risk model also has industry sub-sector scores, which are derived by applying weightings to the 66 risk indicators comprising the basic model. The weightings were developed by the Economist Intelligence Unit's risk team and chief industry analysts, drawing on broad sectoral expertise.

Factors considered in reaching the weightings include the following:

- **How centralised is the production and supply chain?**
- **To what extent is the business intensive in labour, skills and capital?**
- **Does the business rely on cross-border trade in goods?**
- **To what extent is the business reliant on local finance?**
- **To what extent is the business reliant on the domestic market?**
- **How exposed is the business to domestic regulation and public policy?**
- **Does the business operate substantial local operations and facilities?**
- **Does a high social-political profile expose the business to reputational damage?**
- **Does the presence of senior expatriate executives render the business vulnerable to security threats?**
- **How reliant is the business on valuable intellectual property?**

Using this framework, weightings are set on a scale from 1 to 5 to reflect each indicator's importance to investors. The overall score and rating is the sum of the weighted scores of each of the indicators.

The weighting of each risk category in the overall score depends on the weightings of the indicators within it--so if security risk indicators are weighted lower on average than macroeconomic risk indicators, security risk will have a lower weighting in the overall country score. By contrast, in the standard version, each category has an equal weighting in the overall score.

As in the standard model, the scores for each risk category are expressed on a scale of 0-100. In the industry-specific models, the category scores are a weighted sum of the indicators in each category.

Industry scores are directly comparable both to each other and to Risk Briefing's standard scores and ratings.

The industry risk ratings cover 24 sub-sectors belonging to seven industries: energy, healthcare, travel and transport, technology, automotive, consumer goods and financial services.

NATURAL DISASTER RISK CONSIDERATIONS

Natural disaster risk has been omitted from the EIU's operational risk model in the past.

However, it has become increasingly apparent that companies are becoming acutely aware of the impact that natural disasters and climate change-related incidents are having on their businesses. Recent events such as the devastating tsunami in Japan and floods in Bangkok have highlighted the vulnerability of companies' supply chains, and there has been considerable demand from corporate clients for natural disaster risk to be separated out and made a particular area of focus, with equal significance to the other risk categories already within the Risk Briefing model.

In recent years, the EIU has made considerably advanced efforts to incorporate natural disaster risk within its operational risk model, and also has some experience of having done similar work as part of a custom research project, where a company commissioned a specific piece of research that looked directly at this issue when assessing operational risk in a given market for over thirty countries.

A core proposal for incorporating natural disaster risk into the EIU's operational risk model has now been accepted and we are currently looking at different sources for analysts to use in such an assessment, one of which includes for example, the Centre for Research on the Epidemiology of Disasters (CRED), a WHO collaborating body which categorises natural disasters by frequency and impact.