DEALING WITH HIGH-RISK ENVIRONMENTS: INSTITUTIONAL-BASED TOOLS TO REDUCE POLITICAL RISK COSTS

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Abstract

The international business (IB) literature on political risk mitigation has assigned explanatory preeminence to the organizational capabilities of multinational corporations (MNCs). The literature has assumed that political risk is avoidable for MNCs with specific political capabilities. We argue that political risk is inevitable. We posit that even if MNCs have political capabilities, host countries' political risk and its associated costs will not simply disappear. Extending the literature on political risk mitigation, we highlight the role of institutional-based tools in curbing political risk costs. Specifically, we posit that MNCs can reduce political risk costs through (i) international investment agreements, (ii) investment contracts with host governments, (iii) political risk insurance, and (iv) guarantees with binding enforcement mechanisms in unison with relying on political capabilities, thereby dampening the negative effect of uncontrollable host country political risk. We leverage the political-institutional approach to political risk and draw on relevant literature from law and IB to develop a framework to describe the conditions under which MNCs may use these institutional-based tools.

Keywords: Risk mitigation, political risk, cost of political risk, investor-state dispute settlement

1. INTRODUCTION

Multinational corporations (MNCs) are increasingly mindful of the risks they face when operating abroad. This is particularly so in present times, given the rising geopolitical tensions between countries. For instance, due to the ongoing Russia-Ukraine war, over 1000 MNCs have exited or curtailed operations in Russia (Financial Times, 2022b; Sonnenfeld et al., 2022). BP, Exxon, and Shell have all divested billions of dollars in investments in Russia due to political risk (New York Times, 2022a). Russia has responded by restricting investment and capital flows in and out of the country (Financial Times, 2022a). Thus, MNCs are forced to re-examine their operations [in Russia and elsewhere] and unwind investments due to increased political risk, defined as unexpected actions by political host country actors or events in the political system that alter a country's institutional environment in a manner that threatens the economic value of an MNE's assets (Kobrin, 1979). However, as MNCs are pressured to exit or stop investments abroad due to increased political risk, questions remain about how MNCs can shield investments and reduce the cost associated with increased political risk (Markus, 2022; New York Times, 2022a, 2022b). Against this backdrop, we draw on international business (IB) research and integrate insights from law, a discipline rarely leveraged in IB (Cheng et al., 2011; Lan & Heracleous, 2010), to shed light on the question: *How can MNCs reduce political risk costs when such risks occur?*

To answer this question, we draw on the political-institutional approach to political risk (Henisz, 2003; Stevens et al., 2016), and argue that political risk cannot be avoided completely (Dorobantu et al., 2017; Kobrin, 1979), but its cost may be reduced through *institutional-based tools*. Thus, we provide a new perspective for understanding political risk mitigation abroad. We define institutional-based tools as formal, internationally binding agreements, contracts, or other written instruments that define rights and establish obligations between parties and or their subjects. Scholars have examined political risk mitigation strategies associated with market entry decisions (Li et al., 2018; Schotter & Teagarden, 2014), international M&A (Bertrand et al., 2016) as well as ownership and transaction issues (Benito, 1996; García-Canal & Guillén, 2008). Yet, the institutional-based tools MNCs use to reduce costs resulting from political risk – i.e., when events occur – have received surprisingly little attention. This is a crucial omission, given the centrality

of political risk management to MNCs. For instance, a recent survey of over 1000 global executives in over 90 countries found that political risk represents the most pressing concern when doing business abroad (PwC, 2020). Hence, reducing political risk and its associated costs is relevant in theory as well as practice. IB research to date has mainly focused on how MNCs can manage political risk through organizational (nonmarket) capabilities (e.g., Albino-Pimentel et al., 2018; Lu et al., 2014). Several studies have examined MNCs' ability to search for and select powerful local partners to buffer political risks (Bonardi et al., 2006), such as the hiring of former politicians and high-ranking government officials to lobby on an MNC's behalf (Hillman & Hitt, 1999; Kline & Brown, 2019), and integration with key stakeholder groups (Iankova & Katz, 2003). Some have also studied partnering with multilateral institutions such as the IMF (Gamso & Nelson, 2019). Findings are somewhat mixed (Aggarwal et al., 2012; Hadani & Schuler, 2013), but while we overall know much about MNCs' efforts to mitigate political risks through general nonmarket capabilities, little attention has been paid to the institutional-based tools MNCs use to reduce political risks. MNCs rely on institutional-based tools to lessen the effect of political risk on profitability by reducing potential costs. For instance, in 2012, when the Argentinian congress passed laws to nationalize the assets of the largest integrated Argentine oil and gas company, YPF SA, an MNC with a significant stake in YPF SA, Repsol, relied on institutional-based tools and was awarded 5 billion dollars in compensation – approximately half of what it lost (Rucinski et al., 2014), thereby reducing its political risk associated cost.

This article contributes to research in three ways. First, by taking stock of the various streams of prior work on political risk and developing a taxonomy of institutional-based tools available to MNCs to reduce the cost of political risk abroad, it brings together the fragmented extant literature under a common framework, emphasizing the role of institutions in reducing the cost of political risk. In contrast to previous literature that has focused on organization-level capabilities to *avoid* political risk (Buckley et al., 2016; Fernández-Méndez et al., 2015), we argue and illustrate with actual examples that political risk cannot be avoided completely; as such, MNCs rely on a portfolio of institutional-based tools to reduce its cost. Thus, this article provides a novel perspective for understanding how MNCs mitigate political risk abroad and is the first to systematically explicate which

tools MNCs use to reduce political risk costs. Second, the article advances the understanding of how institutional-based tools can substitute for firm nonmarket capabilities (Albino-Pimentel et al., 2018; Dorobantu et al., 2017), especially for less politically savvy and non-politically connected firms. Finally, the article presents a novel taxonomy drawing attention to MNCs' choices of mechanisms in reducing the cost of political risk.We thereby extend prior literature that has proposed generic political risk mitigation strategies such as "avoidance," "cooperation," "imitation," and "flexibility" (e.g., Miller, 1992) or "low involvement" vs. "high involvement" (e.g., Iankova & Katz, 2003). Thus, this article directly responds to Zhu and Sardana's (2020) and Buckley's (2016) calls for IB literature to go beyond offering generic strategies to political risks.

2. THEORETICAL PERSPECTIVES

2.1. International Business and Host Country Political Risk Mitigation

Political risk mitigation is important for MNCs (Buckley et al., 2016; Hagigi & Sivakumar, 2009; Kobrin, 1979). The nature of political risk is different from other types of risks faced by MNCs; they are external, arising from actions taken by a host government – such as a government's decision to go to war, which consequently triggers sanctions that affect MNCs' ability to do business in a host country. As such, while MNCs may have discretion over choices in managing other types of risks (such as foreign exchange risk or cyber security hazards), they have limited control over political risk. Thus, political risk is inescapable. Still, MNCs can reduce the costs and effects of political risk on their bottom lines. In examining how to address such critical risk, the IB literature has so far focused on generic strategies MNCs can use, including attempts to avoid it by partnering with local firms (Bonardi et al., 2006), and developing organizational capabilities (Buckley et al., 2016), building on the notion that firms with unique capabilities are less sensitive to political risk (Albino-Pimentel et al., 2018; Zilja et al., 2022). When operating abroad, these MNCs supposedly rely on their organizational capabilities to protect their assets by exerting political influence on the host country's government (Albino-Pimentel et al., 2018; Baron, 1999).

Miller (1992) categorizes risk mitigation strategies in IB as avoidance, cooperation, imitation, and flexibility. Iankova and Katz (2003) argue that MNCs' political risk mitigation involves low and high-involvement strategies. Zhu and Sardana (2020) propose four political risk mitigation strategies based on MNCs' capabilities and the nature of challenges in the host country: Specifically, (i) compliance-based strategies, (ii) institutional entrepreneurship approach, (iii) political coalition strategies, and (iv) complete avoidance of the host country. Thus, extant studies on political risk have largely focused on the generic strategies (Buckley, 2016; Miller, 1992; Zhu & Sardana, 2020) and internal actions that MNCs can pursue to prevent political risk from occurring (cf. Buckley et al., 2016). In short, the common notion has been that political risk, once managed, rarely or never occurs.

2.2. A Political-Institutional Approach to Political Risk Faced by MNCs

Miller (1992) explains that when operating abroad, MNCs face three broad kinds of risks: (i) general environmental risks, (ii) industry risks, and (iii) firm-specific risks. General risks affect all firms in a particular country. They include political instability, macroeconomic, and social uncertainties. Industry risks affect only firms in a specific industry, such as unexpected changes in consumer demand, but also changes in legislation targeting a specific sector. Firm-level risks are particular to a single firm, such as machine failures or disruptions due to contract termination, as well as political decisions that affect the activities of a given firm, including – as illustrated by the Repsol-YPF case mentioned earlier – outright nationalization of the company's stocks. Our analysis is primarily concerned with risks emanating from a host country's political environment, i.e., political risks – a general environmental risk according to Miller (1992). Political risks include political instabilities, such as legislation changes, forced regime changes, societal unrest, terrorism, civil wars, and generally problematic host country political situations (Kobrin, 1979).

Host-country political risk has been analyzed in the IB literature using a variety of approaches, including the legitimacy-based approach (Darendeli & Hill, 2016; Stevens et al., 2016), the bargaining power approach (Kobrin, 1987; Ramamurti, 2001; Vernon, 1971), and the political-institutional approach (Henisz, 2003; Stevens et al., 2016). The

legitimacy-based approach posits that MNCs must establish legitimacy with host country stakeholders to improve their chances of success (Darendeli & Hill, 2016). The bargaining power approach argues that MNCs with unique, firm-specific advantages relative to host country governments have greater bargaining power at the outset (Adarkwah & Malonæs, 2022; Kobrin, 1987; Ramamurti, 2001). However, after an investment is sunk, bargaining power shifts from the MNC to the host government as the interests of the two parties diverge. The host government may seek to renegotiate terms on existing agreements or unilaterally alter such agreements to appropriate greater returns (Delios & Henisz, 2003). In that case, the MNC's power to prevent the host government from changing the initial bargain decreases, and its political risk increases, as Vernon (1971) noted in his treatise about the obsolescing bargain. The political-institutional approach examines the development of formal institutions in host countries and how such institutions, or the lack thereof, affect MNCs (Buckley et al., 2016). This approach contends that since host governments benefit from altering laws and policies to their advantage, more political checks and balances that reduce governments' ability to change laws or enact new discriminatory ones will decrease political risks (Henisz, 2003; Stevens et al., 2016). The political-institutional approach sees political risk as an endogenous variable (Buckley et al., 2016). It posits that MNCs have "the ability to block adverse and/or promote favorable policy change" within a given context (Henisz, 2003, p. 181). Because we seek to introduce further nuance to the understanding of the institutional-based tools that MNCs use to reduce the cost of political risk abroad, in this article, we rely on the political-institutional approach, which emphasizes country-level formal institutions (Bertrand et al., 2016).

3. MANAGING POLITICAL RISK

3.1. From Generic Strategies to Specific Institutional-Based Tools

Our main argument is that MNCs rely on several institutional-based tools in addition to organizational capabilities to mitigate political risk. Specifically, we argue that institutional-based tools help MNCs reduce political risk costs once such a risk has occurred. We posit that although MNCs may have little to no control over political risk as it emanates from an exogenous environment (Delios & Henisz, 2000; Dorobantu et al., 2017; Kobrin, 1979), MNCs can reduce the effects of such risks on their bottom line by

relying on the institutional-based tools described below. Thus, we argue that the tools described here go beyond the MNCs' organizational capabilities and managerial risk preferences (Baron, 1999; Bonardi et al., 2006; Buckley et al., 2016; Dorobantu et al., 2017) to devise strategic alternatives to manage risk.

After specifying boundary conditions of our examination, we proceed by taking stock and explaining the institutional-based tools MNCs use to reduce political risk costs. Specifically, we distinguish between (i) bilateral international investment agreements negotiated between countries to promote and protect investments in their territories by MNCs of the other(s), but also provide private actors (i.e., MNCs) contractual rights, (ii) political risk insurance, (iii) investment contracts, and (iv) investment guarantees.

3.1.1. Boundary conditions

MNCs' response to host country political risk is not a homogenous phenomenon; firms have heterogeneous tendencies towards host country political risk based on their industry sector (Brouthers & Brouthers, 2003), previous experience (Delios & Henisz, 2000) as well as their organization capabilities (Albino-Pimentel et al., 2018), making these important boundary conditions for the institutional-based tools described in this article.

Thus, in the analyses below, we assume the following boundary conditions. First, earlier studies suggest that MNCs with high-level political connections are less likely to rely on supranational institutional safeguards to protect their assets (Albino-Pimentel et al., 2018; Delios & Henisz, 2000). Thus, firms' political capabilities may substitute for the institutional-based tools described below. Second, it has also been suggested that previous experience in high-risk countries is critical to managing political risk (Buckley et al., 2016; Del Sol & Kogan, 2007; Delios & Henisz, 2003; Lu et al., 2014). Because host countries with similar institutional configurations are likely to exhibit comparable behavioral patterns, MNCs can draw upon their experience in one country to mitigate risk in another. As such, prior experience is a "proprietary asset" that MNCs can rely on to deal with political risks (Del Sol & Kogan, 2007, p. 906) and, therefore, an important boundary condition to the tools described in this study. Third, rulings by investment arbitration tribunals (and as discussed below) suggest that the ability to rely on the institutional-based

tools described in this article is contingent on the MNC's country of origin (Dolzer & Schreuer, 2012) and whether MNCs' activities in a host country are considered "investments."[i] For instance, bilateral investment treaties (BITs), the most common institutional-based tool used by MNCs to file claims against host governments (UNCTAD, 2022), only cover firms from signatory countries that are engaged in activities specifically defined by prevailing treaties between the home and host country. Thus, the institutional-based tools described here may not apply to all MNCs.

Finally, prior work on international investment law shows that MNCs (both from developed and developing countries) engage in "treaty shopping" – a practice where foreign MNCs gain the benefits of international safeguards in a host country by re-routing investments through third countries (Chaisse, 2015). Similarly, we suggest that because MNCs may have little ability to forestall the occurrence of host country political risk and must take the risk as given (Brouthers, 1995), the rational MNC – notwithstanding the industry sector, previous experience, or organization-level capabilities – will rely on institutional-based tools to protect their assets. Specifically, MNCs rely on investment treaties (bilateral or multilateral), investment contracts with the state, political risk insurance, and guarantees to curb the cost of potential political events that affect the firm. In the following, we describe these institutional-based tools in detail.

3.1.2. Investment treaties

IB scholars have long acknowledged that MNCs are vulnerable to the "obsolescing bargain" problem when operating abroad (Gamso & Nelson, 2019; Vernon, 1971). Research suggests that MNCs cannot solely rely on organization-level capabilities – such as experience and political connections – to curb political risks faced or their costs (Buckley et al., 2016). As a result, firms rely on a series of institutional-based tools to reduce the cost of political risk, chiefly bilateral and regional agreements, collectively referred to as "investment treaties." Investment treaties are negotiated and signed by two or more governments to promote and protect foreign direct investment (FDI) in their territories and provide firms and investors with contractual rights in signatory countries (Dolzer & Schreuer, 2012). When investment treaties exist between home and host countries, MNCs rely on such treaties as the first level of protection to reduce political risk.

Indeed, research shows that MNCs are likely to invest more in countries that sign and ratify treaties with their home country (Frenkel & Walter, 2019; Zilja et al., 2022).

There are two main kinds of investment treaties; bilateral and multilateral. Bilateral investment treaties are between two countries, such as the treaty between the United Kingdom and Ukraine (Ukraine - United Kingdom BIT, 1993). Multilateral investment treaties involve multiple countries. An example is the Agreement between the United States of America, the United Mexican States, and Canada (USMCA)[ii]. Both bilateral and multilateral investment treaties work by establishing limits on host countries' ability to expropriate foreign MNCs' assets and set guidelines for effective compensation in case of expropriation, such as allowing harmed MNCs to call on foreign arbitration and seizure of host government assets held outside the host country (Kerner, 2009; Yackee, 2008a). Some investment treaties also provide exemptional treatment for MNCs from signatory countries, such as exemptions from withholding taxes, allowing the transferability of funds in and out of a host country without delay or satisfaction of local performance requirements (e.g., local content targets or export quotas). In addition, most investment treaties have umbrella clauses that protect MNCs by bringing obligations or commitments that the host country has entered with other countries in connection with FDIs under the protective "umbrella" of the treaty. Investment treaties may also provide national treatment rights to MNCs that compel host governments to make no differentiation between foreign and local firms when enacting and applying rules and regulations (Allee & Peinhardt, 2011). Many countries often encourage foreign MNCs to invest in their territories but protecting domestic firms against foreign MNCs is also a common occurrence (UNCTAD, 2020). National treatment provisions in investment treaties shield MNCs against such discrimination, thereby absorbing MNCs from being at a competitive disadvantage.

In summary, most investment treaties guarantee MNCs' rights to enter and establish operations in a host country. They also assure fair treatment post-establishment. As illustrated in Figure 1 and Table 1, the popularity of investment treaties has increased substantially in the past decades, with over 80% of all known investor-state dispute-settlement cases initiated using investment treaties (UNCTAD, 2022), emphasizing that many MNCs rely on investment treaties to reduce political risk exposure and cost. As

shown in Table 1, since 1993, MNCs have been awarded close to 500 billion dollars in damages to cover political risk costs.

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For instance, in 2014, the Moscow and London listed vertically integrated oil and gas company, Tatneft relied on institutional-based tools to reduce its political risk cost when it was awarded 112 million dollars by the Permanent Court of Arbitration (2014) for losses it incurred following the takeover of its shares in the oil refining company, Ukrtatnafta by the government of Ukraine. Returning to the ongoing Russia-Ukraine war, after the annexation of Crimea in 2014, Russia enacted several laws establishing new conditions under which banks could operate in Crimea. A month later, the commercial bank, Oschadbank, was forced to cease operations in Crimea for lack of compliance with the new directives. In 2016, Oschadbank initiated an arbitration process against Russia under the Russian-Ukrainian BIT from 1998. The Permanent Court of Arbitration (2016) awarded over 1.3 billion dollars in compensation to Oschadbank. Thus, Oschadbank was able to reduce its political risk cost in Crimea by a substantial amount through institutional-based tools[iii]. Likewise, in 2017, Ukraine's largest national oil and gas company, Naftogaz initiated arbitration against Russia under the Russian-Ukrainian investment treaty for 8 billion dollars in compensation for the alleged expropriation of its oil and gas assets in Crimea by Russia and the transfer of assets to a Russian state-owned company (Financial Times, 2019). Since 2014, MNCs have relied on international-based tools and successfully sued for billions of dollars in compensation to reduce political risk costs (Financial Times, 2019). Since it annexed Crimea in 2014, Russia alone has faced at least 15 new investment treaty arbitrations, with others threatened (UNCTAD, 2022)[iv].

Investment treaties are not only effective in situations of war. They also cover political risks that emanate from governments' unilateral decisions. For instance, in 2002, when Mexico introduced a new tax on beverages containing high fructose corn syrup, it affected the profits of the high fructose corn syrup industry. Cargill Inc, an American global food corporation, sued Mexico for compensation for its economic losses arising from the taxes. Cargill was awarded 77.30 million dollars. Based on Table 1, which gives an overview of recent arbitration awards, we posit that investment treaties can be effective in

reducing the cost of political risk abroad. However, investment treaties are not without limitations; for instance, investment treaties apply to only investments made *after* the treaties are effective. Thus, not all MNCs can rely on treaties to reduce the cost of political risk abroad. In addition, most treaties permit host countries to set aside investor rights under a treaty for matters of national interest or morality purposes. For instance, the German-Russian investment treaty allows both countries to set aside investors' rights for "…measures undertaken in law and order and security, morality or public health" (Germany - Russian Federation, 1989, p. 8). Furthermore, most investment treaties protect only *investments* by qualified *investors* – based on the so-called Salini criteria[v]. Thus, while treaties are popular among MNCs, they do not cover the cost of political risk for all MNCs – only those from signatory countries with investments after the treaty was put in place. Consequently, MNCs supplement treaties with other institutional-based tools – specifically, investment contracts, political risk insurance, and guarantees – in unison with organizational capabilities.

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3.1.3. Investment contracts

Foreign investments are long-term commitments, and large-scale investment projects can last for decades. However, the general legislation of host countries is seldom static. Investment treaties may expire, and the host government's interests may change and subsequently engage in hold-ups (Vernon, 1971). For instance, Wellhausen (2015) reports that between 1990 and 2008, the Ukraine government expropriated assets from 12 US firms following disputes with the MNCs. As a result, the MNCs relied on investment contracts they had with the government, sued, and won compensation, i.e., effectively reducing the costs of the political risk.

Investment contracts are private agreements negotiated between MNCs and host governments (unlike treaties which are between governments). Most investment contracts regulate the applicable laws and define the mechanisms for settling disputes, such as binding international arbitration (Wellhausen, 2015; Yackee, 2008b). Thus, investment contracts provide MNCs with substantive and procedural rights in terms of disputes with the host governments. Most importantly, many investment contracts contain stabilization

clauses that ensure a stable interpretation or application of local laws over the lifespan of the investment. Stabilization clauses provide MNCs with a predictable investment environment where government officials cannot arbitrarily change laws or their interpretations to the detriment of MNCs (Dolzer & Schreuer, 2012).

Investment contracts are most prevalent in the natural resources sector, where host governments own the resources, and MNCs contracted to exploit such resources or provide an essential public service such as the provision of electricity, whereby the nature of transactions requires negotiation of specific terms between the MNC and host government (Yackee, 2008b). However, contracts are also increasingly found in other sectors. For instance, as Spar (1998) notes, before Intel Corporation invests in any new semiconductor facility construction, it makes sure it has a signed investment contract with the host government before the investment is sunk. We suggest that MNCs rely on investment contracts to reduce political risk as they provide stability and predictability for the host country's environment. Investment contracts are effective tools for MNCs because they allow MNCs to negotiate the details of terms and sometimes even draft the terms tailoring them to their specific investment needs (Yackee, 2008b). In addition, and like treaties, a breach of investment contracts allows harmed MNCs to call on international arbitration and seize host government assets outside the host country (Berger, 2003). As shown in Figure 1, the popularity of investment contract-based arbitration has increased substantially in the past decades, evidencing that MNCs increasingly rely on investment contracts to reduce the cost of political risk abroad.

Investment contracts with host governments allow MNCs to reduce the cost of political risk through legal means by providing MNCs with rights and procedures to enforce those rights in case of disputes with the host governments (Wellhausen, 2015; Yackee, 2008b). However, not all host governments are willing to sign investment contracts with foreign MNCs (Guzman, 1997). Even if they do, once the MNC has invested in a host country, and the investment is evidently successful, the risk of the "obsolescing bargain" problem will persist (Vernon, 1971). The host governments may breach the investment contracts with MNCs for their interests. Many host governments deliberately breach contracts to achieve national and political objectives, such as raising revenues or catering to domestic or foreign policy interests. For example, during its 2002 default,

Argentina broke several foreign contracts to stay afloat. In 2016, political tensions between Lithuania and Russia led to the Lithuanian government breaching its contracts with Russian MNC Yukos (Kramer, 2006). Likewise, the ongoing Russia-Ukraine war has led to Ukraine potentially breaching several protections afforded to MNCs under its investment treaties and contracts (OECD, 2022), leading to several potential treaty-based litigations in the future[vi]. In addition, investment contracts are costly to enforce, in which MNCs pay, on average, 5 million dollars in lawyers' fees on top of contributing to tribunal fees, which can reach in excess of 1 million dollars per case (Franck, 2014). Such risks and costs inherent in investment contracts (and treaties) have led to the evolution of a market for political risk insurance schemes – signed between MNCs – in addition to treaties and contracts to reduce political risk costs. Notably, insurance reduces political risk and its cost as it cannot be set aside unilaterally by host governments and can be tailored to cover specific events such as wars.

3.1.4. Political risk insurance

> *"The purchase of political risk insurance is one of the most direct and simplest steps that an investor can take to reduce exposure to political risk"* (Comeaux & Kinsella, 1997, p. 163)

As noted in the quote above, evidence suggests that political risk insurance can be an effective way to reduce political risk costs (Comeaux & Kinsella, 1997). MNCs rely on political risk insurance as a financial backup in the occurrence of political risks, thereby ensuring financial stability for the MNC. Political risk insurance has been around since the early 1950s. In its early years, political risk insurance services were dominated by state-run insurance agencies that sought to promote the outward FDI of their nations. For instance, the United States offered political risk insurance under the Marshall Plan to cover American MNCs investing abroad. In 1971, political risk insurance under the Marshall Plan was replaced by the Agency for International Development. Other countries, including Germany, the United Kingdom, Norway, France, and Japan, have similar programs. The goal of such international investment insurance is tied to the promotion of the national

economy, with protection only being granted to national companies and projects in countries friendly to the issuing government (Dolzer & Schreuer, 2012). Thus, in effect, political risk insurance programs reflected the foreign policy goals of the home country (Lu et al., 2014).

In the mid-1970s, private insurance companies entered the political risk insurance market, beginning with Lloyd's of London and American International Group. Moreover, the member states of the World Bank established the Multinational Investment Guarantee Agency (MIGA) to offer political risk insurance and credit enhancement guarantees to protect FDI against political and non-commercial risks abroad. At the regional level, the Islamic Development Bank was established to underwrite political risk insurance for the Arab region (Shihata, 1972).

The political risk insurance industry categorizes political risks into three broad categories: (1) war and political violence, (2) expropriation/breach of contract, and (3) transfer risk (Jensen, 2008). Events such as the ongoing Russia-Ukraine war are associated with the direct or indirect impact of political violence, such as civil war, uprisings, or some types of terrorist attacks. Such risks are covered by political risk insurance (Peinhardt & Allee, 2016). Notably, political risk insurance is expensive. As such, not all MNCs can afford to rely on them to protect their investments. For instance, MIGA charges between 0.3 and 1.75 percent of the invested sum as an annual premium paid at the beginning of each contract period (Gianturco, 2001). Despite its cost, however, MNCs rely on political risk insurance to reduce the cost of political risk as they cannot be set aside or abrogated by host governments. A recent analysis by Arel-Bundock et al. (2020, p. 6) on US MNCs' political risk insurance filings shows that "when claims are settled, firms receive around 90% of total claims on average." Thus, political risk insurance shelters MNCs from the risk of final loss in political risk events.

3.1.5. Guarantees

Many countries provide government-backed guarantees to MNCs to encourage foreign investments. For example, the Japan Bank for International Cooperation (2022) provides investment guarantee support for equity acquisitions by Japanese MNCs in foreign countries (JBIC, 2022). Government-backed investment guarantees aim to mitigate frictions in outward FDI by compensating MNCs for losses broad due to political events.[vii]

For instance, it is well known that the Chinese government "specifically promotes outward FDI for the interest of its national economic development and the growth of individual Chinese firms" (Luo et al., 2010, p. 69). Guarantees have been debated for their potential to act as a subsidy, giving foreign MNCs an unfair advantage over local firms. However, nearly all developed countries and an increasing number of emerging economies now have some form of a guarantee scheme for outward FDI. Guarantees are similar to political risk insurance but differ in their coverage for trading activities, i.e., export, which are not protected by most investment treaties and investment contracts. MNCs prefer investment guarantees because they are less costly than political risk insurance (Gordon, 2008; Moser et al., 2008). For instance, in Germany, the government offers guarantee programs integrated into the states' federal government accounts. As a result, all disbursements associated with claim costs incurred during the lifespan of the guarantee are paid out from federal government funds, thereby reducing the cost of premiums to MNCs (Moser et al., 2008). Consequently, in the absence of a treaty between MNCs' home and host countries, MNCs are likely to reduce political risk costs by relying on investment guarantees.

3.2. A Framework for Reducing the Costs of Political Risk Abroad

The institutional-based tools described above go beyond the MNCs' own organizational capabilities and managerial risk preferences to devise strategic alternatives to manage host country political risk and its cost. However, using the tools described above depends on the institutional arrangements of the home and host countries (which determine the availability of these tools), as well as on the nature of the economic activity, i.e., whether it is considered an investment as defined in existing institutional arrangements. As presented in Figure 2, the type of activity MNCs undertake and the destination country in which they choose to undertake such activities are influenced by the MNCs' motives and capabilities (Kim & Aguilera, 2016; Lu et al., 2014; Zilja et al., 2022) and by host countries' institutions and investment policies, such as whether there is investment agreement between the MNCs home and host country. We argue that the combination of MNCs' motives and capabilities, in addition to home and host country institutional arrangements, affect the types of investments MNCs pursue, which determines the possible institutional-based tools available to the MNC to reduce the cost of political risk should

such risk materialize. Thus, our framework, depicted in Figure 2, extends previous analyses by scholars such as Miller (1992), Iankova and Katz (2003), Buckley et al. (2016), Gamso and Nelson (2019), Zhu and Sardana (2020), and Cavusgil et al. (2020) of how MNCs mitigate host country risk *before* investments are committed.

---- INSERT FIGURE 2 HERE ---

Our framework rests on the assumption that MNCs are rational actors, but boundedly so (Surdu et al., 2021). That is, notwithstanding their organizational capabilities, given the option, MNCs will choose to protect their investments against political risks in host countries. In addition, we acknowledge that international investment protection is done on a case-by-case basis, with the actual decision regarding the political risk reduction tool or a combination thereof being made based on a firm's assessment of the host country's environment, which ultimately depends on the economic activity in question. The choice also depends on the availability and cost of using a particular institutional-based tool for handling political risk. Finally, our framework considers that MNCs, as well as countries (home and host), assess and learn from their experiences with institutional-based tools (Surdu et al., 2021); hence a feedback loop is depicted as stippled lines in Figure 2.

Investment treaties have been the focus of much recent IB research (Albino-Pimentel et al., 2018; Jandhyala & Weiner, 2014; Zilja et al., 2022), but are – as shown here – not the only institutional-based tool that MNCs use to reduce the cost of political risk. Complementary tools include political risk insurance, investment contracts, and guarantees. Figure 3 presents a taxonomy (Doty & Glick, 1994; Hotho, 2014) of four feasible tools to reduce the cost of political risk. The applicability of each tool depends on two considerations: (1) the MNCs' economic activity and (2) the existing institutional relations between MNCs' home and host countries.

---- INSERT FIGURE 3 HERE ---

Cell 1 covers political risk insurance. MNCs rely on political risk insurance to reduce the cost of political risk when there are neither bilateral nor multilateral investment treaties between their home and a host country, and at the same time being involved in activities not considered by the host country as investments. Cell 2 comprises guarantees,

which MNCs rely on to reduce the cost of political risk when their activities are not considered investments by existing investment treaties, and when the MNC's home country government seeks to promote its external competitiveness by encouraging outward FDI (Luo et al., 2010). As depicted in Cell 3, when an MNC is engaged in investments, but there are no investment treaties between the home and host countries, it is more prudent for the MNC to negotiate and sign investment contracts with the home government. The investment contracts should include binding international commercial arbitration mechanisms to be activated in the occurrence of political risk events, so the MNC may claim compensation to reduce related costs. Finally, as shown in Cell 4, when MNCs' home and host countries have signed and ratified bilateral or multilateral investment treaties, MNCs rely on such treaties to reduce the cost of political risk in the host country in case of expropriation. When applicable, investment treaties are free and effective in reducing the cost of political risk. MNCs can call on external arbitrators and ask for compensation to cover losses induced by host government actions or inaction. Table 2 presents a summary of the institutional-based tools for curbing political risk costs, including actual cases and empirical studies.

---- INSERT TABLE 2 HERE ---

3.3. An Example: How Tatneft Reduced its Political Risk Cost by 112 million Dollars

We illustrate how MNCs use the institutional-based tools identified in this article to reduce political risk costs with the earlier discussed case of Tatneft v. Ukraine.[viii] Thus, our example directly applies to types 3 and 4 in the taxonomy, as presented in Figure 3 but may also apply to types 1 and 2. In type 1, the dispute process will be between two MNCs (an MNC and its insurer); in type 2, it will be between an MNC and its home government or a representative of the home government.

3.3.1. Initial phase: The facts and the request for consultation

In 1995, Moscow and London-listed MNC, Tatneft entered the Ukrainian market through a joint venture (JV) with the government of Ukraine and the Republic of Tatarstan (a Russian constituent state) for the establishment of an oil refinery "Ukrtatnafta." In 1999, two additional MNCs, Seagroup (from the United States) and AmRuz (from Switzerland),

joined the JV as shareholders. In January 2007, a local firm, the PrivatBank Group, acquired a percentage interest in the JV. Later that year (December 2007), Tatneft acquired full ownership of Seagroup and AmRuz, making Tatneft the majority shareholder of Ukrtatnafta. The acquisitions by Tatneft drew lots of criticism and even a lawsuit, as many Ukrainians saw the foreign majority control of the largest refinery against their national interest (Tatneft v. Ukraine, 2014). In 2008, PrivatBank Group (the local investor) initiated litigation to invalidate the JVs agreement by which the Republic of Tatarstan and Tatneft obtained their ownership in Ukrtatnafta (to ensure local control of the JV). PrivatBank Group won. This led to a loss of ownership and, consequently, Tatarstan and Tatneft representatives being barred from the management of Ukrtatnafta. PrivatBank Group initiated further litigations against Ukrtatnafta (the JV) and its management to compel Ukrtatnafta to sell the shares formerly held by AmRuz and Seagroup (acquired by Tatneft in December 2007) at auction. The local court granted this request without informing Tatneft and the other shareholders (Tatneft v. Ukraine, 2014). Upon becoming aware of the ruling, Tatneft appealed the decision but was dismissed by a local court in Ukraine. Thus, in effect, Ukrainian courts invalidated Tatneft ownership in the JV. The management of Tatneft concluded that the loss of ownership in the JV amounted to an act of expropriation by Ukraine; as such, Ukraine had violated its obligations to Tatneft under the Russia-Ukraine BIT of 1998, i.e., to provide "complete and unconditional legal protection" to qualified investments:

> *"Each of the Contracting Parties guarantees in accordance with its legislation the complete and unconditional legal protection of investments made by investors of the other Contracting Party."* Article 2.1 Russian - Ukraine BIT (1998)

3.3.2. Negotiation phase: Notice of dispute and request for negotiations

In December 2007, Tatneft requested consultation and negotiation with the government of Ukraine (notice of dispute). The government obliged. Consultation and negotiation commenced but could not come to an agreement (Reuters, 2008; Tatneft v. Ukraine, 2014: 8). Consequently, Tatneft invoked its right under the Russian - Ukraine BIT (1998) and called on external arbitration against the government of Ukraine at the Permanent Court of Arbitration in Paris (Tatneft v. Ukraine, 2014):

> *"In the event a dispute cannot be resolved through negotiations within six months as of the notification in writing of the origin of a dispute, then at the request of either Contracting Party, it shall be passed over for consideration, to the arbitration tribunal."* Article 10.2 Russian - Ukraine BIT (1998)

3.3.3. Arbitration phase: Negotiations failed to reach an amicable agreement

In May 2008, Tatneft served the government of Ukraine with the formal "notice of arbitration." Tatneft requested that Ukraine pay its "1.073 billion dollars as compensation for losses associated with its investment in the JV. The Permanent Court of Arbitration screened and reviewed the request based on the institutional-based instrument and procedures, i.e., the Russia-Ukraine BIT (1998), and registered the arbitration request. After registration, it proceeded with the selection of tribunal members. The Russia-Ukraine BIT (1998), like most modern investment protection instruments, sets out a procedure for selecting members of the arbitral tribunal:

> *"The Contracting Parties, each of them, shall appoint one member of the arbitration tribunal within two months as of the receipt of notification of hearing to be held by an arbitration tribunal [...]."* Article 10.2 Russian - Ukraine BIT (1998)

In June 2008, Tatneft appointed Professor Rudolf Dolzer of the University of Bonn as its arbitrator. The government of Ukraine appointed Marc Lalonde, a former Canadian attorney, as its arbitrator. Both appointees appointed the presiding member of the panel, Professor Francisco Orrego Vicuna of the University of Chile. Article 11 of the UNCITRAL Rules permits parties to object to an arbitrator's appointment on the grounds of apparent bias. Ukraine objected to Tatneft's appointment of Professor Dolzer. In his place, Tatneft appointed Charles Brower, a former US State Department official, as its arbitrator. The arbitration tribunal was then constituted. In September 2010, the tribunal issued its award on jurisdiction (the "award on jurisdiction"), where it formally affirmed jurisdiction over the dispute. In November 2010, at its "First Session," the tribunal issued a procedural schedule for the merits phase. In June 2011, Tatneft submitted its written submission and supporting documents. In December 2011, Ukraine submitted its response. After receipt of the written submissions and supporting documents, on the 18th of March 2013, deliberations commenced where the arbitration tribunal examined the facts as well as called in expert witnesses invited to testify. On 29th July 2014, the tribunal issued its

ruling (merit award) in favor of Tatneft. Stating that Ukraine *“bears international responsibility—or liability in principle—toward [Tatneft] under the Russia-Ukraine BIT as a result of its conduct in the period between 2004 and 2007 and the associated breaches of certain BIT provisions” (Tatneft v. Ukraine, 2014: 152).*

The tribunal further stated that Ukraine’s actions resulted in a “total deprivation of [Tatneft’s] rights as a shareholder of Ukrtatnafta.” Thus, Ukraine had expropriated Tatneft’s assets under the Russia-Ukraine BIT of (1998) and must pay compensation to Tatneft:

> *“(1) The Respondent (government of Ukraine) shall pay the Claimant the amount of USD 112 million as compensation for its breaches of the Russia-Ukraine BIT.*
> *(2) The Respondent shall pay the Claimant interest on the amount awarded in subparagraph (1) at the interest rate for three months deposits in US dollars at the LIBOR rate plus 3%. Interest shall begin to accrue on the amount of USD 68.44 million on 12th May 2009, and on the amount of USD 43.56 million on 27th January 2010, and shall continue.” (Tatneft v. Ukraine, 2014: 152)*

Ukraine applied to set aside the ruling, but the application was dismissed. Thus, after several failed attempts to rely on organizational (nonmarket) capabilities and political connections to avoid losing its stake in the JV, the political risk persisted, and Tatneft lost its ownership in Ukrtatnafta. But, through the institutional-based tools, Tatneft was able to reduce its political risk cost by 112 million dollars, a substantial amount for any firm.

Likewise, in 2014, when the Ukrainian parliament adopted a law to amend its tax code and raise royalties on gas production from 28 to 55 percent as well as required private companies to purchase gas solely from the state entity, Naftogaz, British MNC, JKX Oil & Gas plc, relied on the institutional-based tools and successfully sued the Ukrainian government for reimbursement of over 180 million dollars. The examples of Tatneft and Naftogaz in Ukraine illustrate how MNCs can respond to political risk, emphasizing the importance and effectiveness of the tools described in this article. Thus, the institutional-based tools effectively reduce the cost of the political risk when nonmarket capabilities fail (Buckley et al., 2016; Fernández-Méndez et al., 2015).

Figure 4 summarizes a typical process MNCs go through when using the institutional-based tools identified in this article to reduce the cost of political risk.

---- INSERT FIGURE 4 HERE ---

In summary, the protections offered by the institutional-based tools begin with the MNC making qualified investments that meet "the Salini criteria." After the investment is sunk, if a dispute arises, the MNC assess whether the host country's actions constitute a breach of its rights under the specific institutional-based tool that governs its investment in the host country. If so, the MNC may request a consultation and negotiations with the host government to settle their differences by sending a "request for consultation". Consultation and negotiation are direct discussions between the MNC and the host government without third parties. If consultation and negotiations fail to produce an amicable solution, the MNC may call on external arbitrators to resolve the dispute by filing a "request for arbitration" (if under ICSID rules) or "notice of arbitration" (if filed under UNCITRAL proceedings) and pay a non-refundable "lodging fee." ICSID, for instance, charges 25,000 dollars per filing (ICSID, 2022). The dispute settlement proceedings formally commence when the request for arbitration is registered by the arbitration tribunal. The MNC and the host government then determine the criteria for the selection of arbitrators. Most treaties and investment contracts regulate how the tribunal must be constituted, including the number of arbitrators, the method of their appointment, and their characteristics (see Russia-Ukraine BIT (1998), for example)). Generally, arbitrators must be of (1) high moral character, (2) well-recognized competence, and (3) independent judgment.

After the appointment of arbitrators, the tribunal then holds its "first session" – to discuss procedural matters, including rules, procedural language(s), dates and locations for proceedings, dates for written and oral pleadings and supporting documents, as well as a decision on whether the proceedings will be held public or kept secret. Most arbitration procedures are held behind closed doors, but some are open to the public. After the first session, parties are asked to present their written arguments (submissions), stating the facts and supported by relevant documentation. After receipt of the written submissions, the tribunal sits for deliberation, where the MNC and the host government present their oral arguments. If necessary, external witnesses are invited to testify during the deliberations.

Based on the deliberation, the tribunal issues its ruling (i.e., merit award). Rulings by arbitration tribunals are final and enforceable in all signatory states of the New York convention. For instance, the Russia-Ukraine BIT (1998) specifies that:

> *"The award of arbitration shall be final and binding upon both parties to the dispute. Each Contracting Party shall undertake to execute such an award in conformity with its respective legislation"* Article 9.3 Russian - Ukraine BIT (1998)

Rulings based on the institutional-based mechanisms described in this article have the same effect as rulings by local host country courts with the added advantage of impartiality, as MNCs can choose arbitrators. Thus, the institutional-based mechanisms are credible means accepted at the international level to protect MNCs against political risks existing in host countries.

3.4. The Distinction between Institutional-based Tools and Generic Political Risk Mitigation Strategies

So far, we have discussed and illustrated with practical examples how MNCs use institutional-based tools to reduce the costs of political risk. We stress that the four types in the taxonomy discussed above complement MNCs' risk mitigation strategies so far highlighted in IB, i.e., those based on MNCs' organizational capabilities (Buckley et al., 2016; Miller, 1992). However, the institutional-based tools differ substantially from MNCs' organizational capabilities. Although risk mitigation strategies based on MNCs' organizational capabilities may prevent some political risks from materializing (Albino-Pimentel et al., 2018; Buckley et al., 2016), once the risk occurs, MNCs' organizational capabilities cannot readily reduce the effect of political risk costs on their profits, an important firm-level goal (Hillman & Hitt, 1999). But, investment treaties, political risk insurance, investment contracts, and guarantees which allow MNCs to claim compensation from offending governments, can. The MNC may initiate an investor-state arbitration proceeding against the host government for compensation for loss from expropriation (see Tables 1 and 2). Such a payment eases the total loss incurred by the MNC due to political risk. In addition, the MNC may register a claim with its political risk insurance carrier or investment guarantee agency for compensation. The key point, as supported by actual cases

(see example above), is that institutional-based tools allow MNCs to reduce the cost of political risk when it occurs. Organizational capability-based strategies such as the hiring of high-ranking government officials on the MNCs board (Hillman & Hitt, 1999; Kline & Brown, 2019), integration with local stakeholder groups (Iankova & Katz, 2003) or campaign contributions (Albino-Pimentel et al., 2018) do not (see Liedong et al., 2017; Puck et al., 2013). Thus, we argue that there is a need to go beyond organizational capabilities to understand how MNCs deal with political risk and its associated costs.

4. IMPLICATIONS AND FUTURE RESEARCH DIRECTIONS

By nuancing the essential institutional-based tools MNCs use to reduce the cost of political risk abroad, our analysis has identified several important implications for future research. The IB literature has mainly focused on how MNCs deal with political risk using their own organizational capabilities (Albino-Pimentel et al., 2018; Buckley et al., 2016; Miller, 1992; Zhu & Sardana, 2020). Thus, the literature has taken an implicit assumption that political risk, once managed, does not occur or is of little consequence. As a result, the important issue of how MNCs can reduce the cost of political risk when it occurs has essentially been ignored in the literature. However, political risk cannot be fully avoided (Kobrin, 1979), and our analysis show how MNCs can effectively reduce political risk costs. We systematically synthesize a diverse but scattered body of literature from IB and law on the tools that enable MNCs to reduce political risk costs.

With the current trend of increasing geopolitical tension between countries, wars, and policy uncertainties (Adarkwah, 2022; Benito et al., 2022; Witt et al., 2023), this article opens several research possibilities. First, the obsolescing bargain hypothesis (Vernon, 1971) suggests that host governments may opportunistically expropriate MNCs' assets if deemed beneficial to them. Yet, MNCs that rely on institutional-based tools such as investment treaties and contracts place their trust in host governments. Considering recent heightened levels of national conflicts, such as the ongoing war between Russia and Ukraine that has seen a host of MNCs leave Russia (Financial Times, 2022b), terrorism, corruption, and fraught political regimes, how can MNCs ensure that host governments respect the sanctity of investment contracts and treaties? Second, as shown in Figure 1, over the last 27 years, expropriations – and consequently the number of investor-state

disputes – have increased considerably worldwide (UNCTAD, 2020). Under what circumstances should MNCs not trust host governments to respect the institutional-based tools available to reduce the cost of political risk? Third, although many governments are desperate for FDI, they are also eager to govern. How should governments and policymakers manage their relationship with foreign MNCs to ensure that they attract more FDI while exercising their authority and rights to regulate their environments? Finally, although many studies have identified the *ex ante* benefits of some of the institutional-based tools, such as the effect of the signing of investment treaties on host countries' attractiveness to FDI (Albino-Pimentel et al., 2018; Frenkel & Walter, 2019; Jandhyala & Weiner, 2014; Zilja et al., 2022), the *ex post* outcomes of the institutional-based tools have been ignored in the literature (Jandhyala & Weiner, 2014). Thus, there is a need to examine the *ex post* effect of disputes between MNCs and host governments on the attractiveness of host countries as FDI destinations. For instance, does being sued by MNCs using the institutional-based tools poison the host country's environment for inward FDI? Using our analysis as a foundation, future research can help answer these pressing questions for business leaders, governments, and policymakers.

5. CONCLUSION

This article provides an integrative view of the various institutional-based mechanisms MNCs use to mitigate the negative consequences of political risk; specifically, the costs resulting from the political risk actions. Our central argument is that in addition to political capabilities, MNCs also rely on several institutional-based tools to mitigate political risk. We argue that institutional-based tools may reduce the cost of political risk on MNCs' bottom line when such risks occur. Thus, as IB research continues to disentangle how best MNCs can mitigate political risks abroad, we should not forget what are arguably the most important artilleries for shielding FDI; (i) international investment agreements, (ii) investment contracts with host governments, (iii) political risk insurance, and (iv) guarantees with binding enforcement mechanisms. Underlying these tools is the argument that although political risk cannot be avoided completely, MNCs can reduce the cost of such risks should they materialize.

This article makes several specific contributions to the study of political risk. First, although the literature on political risk has burgeoned in the past decades (Kobrin, 1979), it has remained fragmented (Cheng et al., 2011; Lan & Heracleous, 2010). This article synthesizes multiple streams of research that have hitherto been seen as largely distinct (Cheng et al., 2011) and highlighted the connections among them. Specifically, it underscores, with actual MNC-host government disputes such as Tatneft v. Ukraine (PCA Case No. 2008-8), that the identified institutional-based tools are fundamental in dealing with host country political risks. This is novel as it demonstrates that firms' nonmarket capabilities, which have received explanatory primacy in the extant host country risk literature (Buckley et al., 2016), may not be adequate in dealing with host country political risks when the risk actually occurs. Thus, while previous perspectives have mainly conceptualized political risk abroad as something that, once managed, hardly ever occurs (Buckley et al., 2016; Miller, 1992), our alternative perspective views political risk as inevitable; as such, MNCs must endeavor to reduce its effect on their bottom line. Hence, viewed through the perspective we offer, institutional-based tools such as investment treaties are not just relevant to firms lacking political competence or political connections, as has, for example, been argued by Albino-Pimentel et al. (2018), but are pertinent for the great majority of MNCs investing abroad. As the experience of Tatneft demonstrates, political risk is inescapable, even for politically competent and highly connected MNCs. The institutional-based tools identified in this article reduce the negative effects on firms.

Second, our article not only highlights the importance of institutional-based tools in reducing the cost of political risk but also draws attention to MNCs' choices among them. By explicating the requirements MNCs fulfill to utilize the institutional-based tools, we offer a foundation to predict and inform managerial decisions on political risk management when investing abroad and thereby offer an exciting new agenda for research in IB and the risk management domain. For instance, understanding the factors that drive managerial choice when multiple institutional-based tools are available to the MNC is important in informing managerial decision-making in this increasingly important area.

Finally, and more generally, our article contributes to the study of nonmarket strategy (Baron, 1999; Buckley et al., 2016). Specifically, we advance the understanding of how institutional-based tools can substitute for firm nonmarket capabilities – a central

theme in the nonmarket strategy literature in addressing risks existing in host country institutional environments (Albino-Pimentel et al., 2018; Buckley et al., 2016). By conceptualizing political risk mitigation beyond MNCs' nonmarket capabilities, we have highlighted the importance of institutional-based tools, from which future research on nonmarket strategies may benefit.

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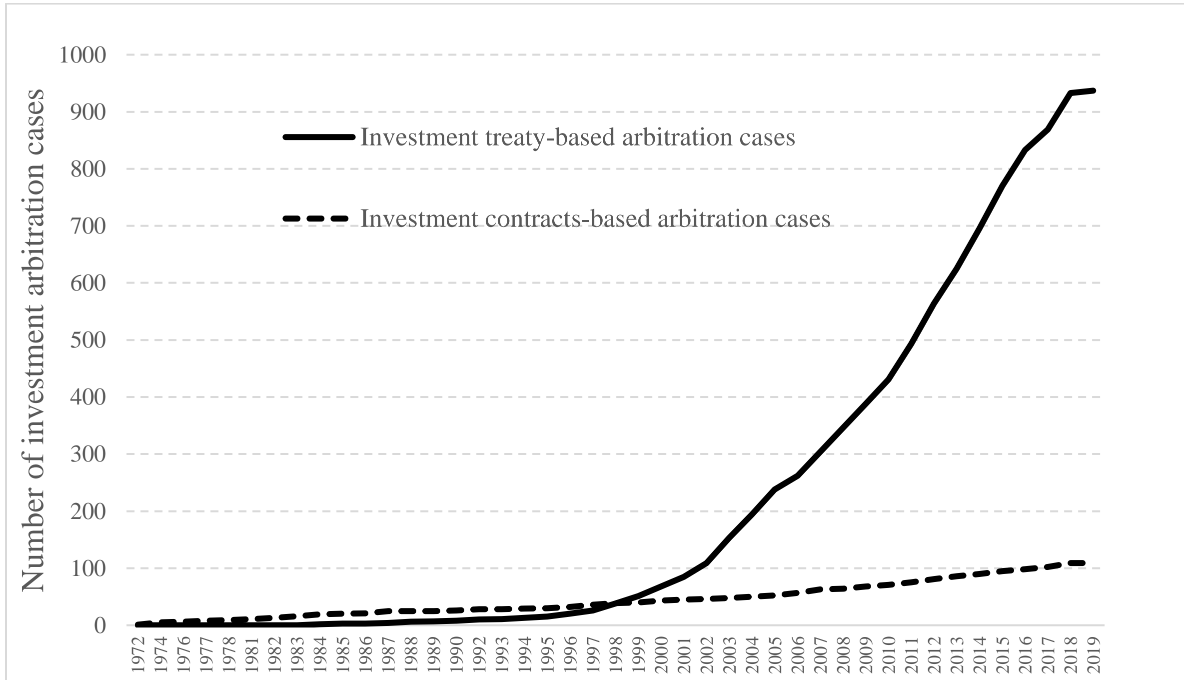
Figure 1: Increasing popularity of investment treaties and contract-based investor-host state arbitration cases (1974 – 2019).



Source: Data from The World Bank's International Centre for Settlement of Investment Disputes (ICSID) (https://investmentpolicy.unctad.org/). ICSID is the most popular venue for international arbitration. Disputes are also filed under the United Nations Commission on International Trade Law (UNCITRAL), the Permanent Court of Arbitration, the Stockholm Chamber of Commerce, and the London Court of International Arbitration.

Figure 2: Interactions between the MNC, host and home country environment, investment project, and political risk mitigation strategies.

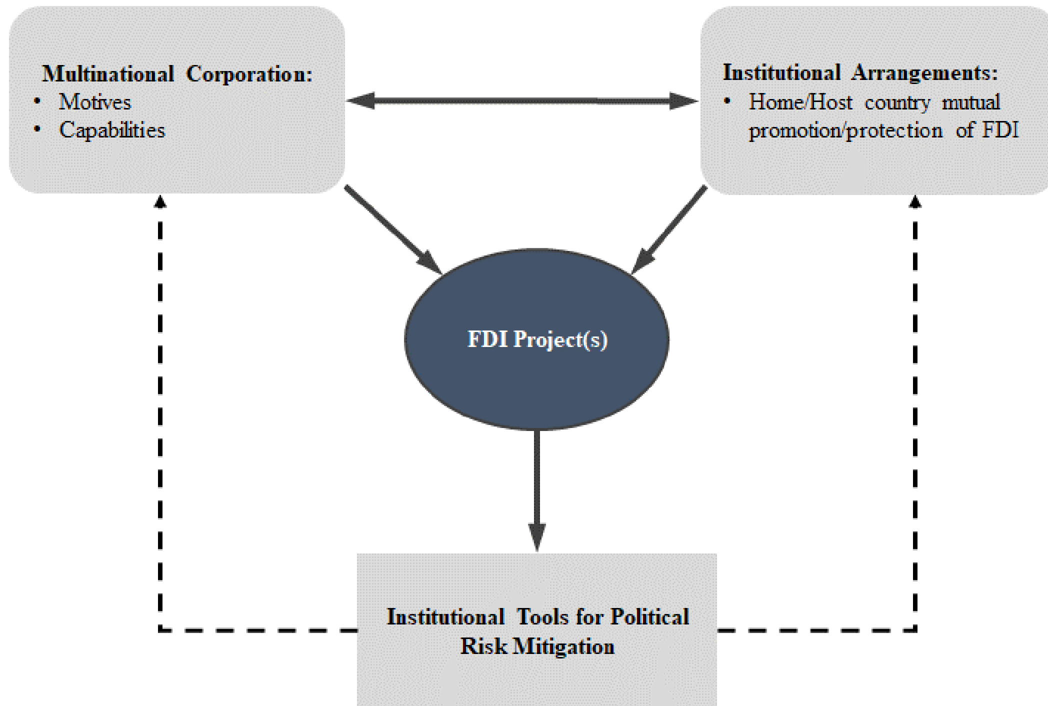


Figure 3: A taxonomy of institutional-based tools to reduce the cost of political risk.

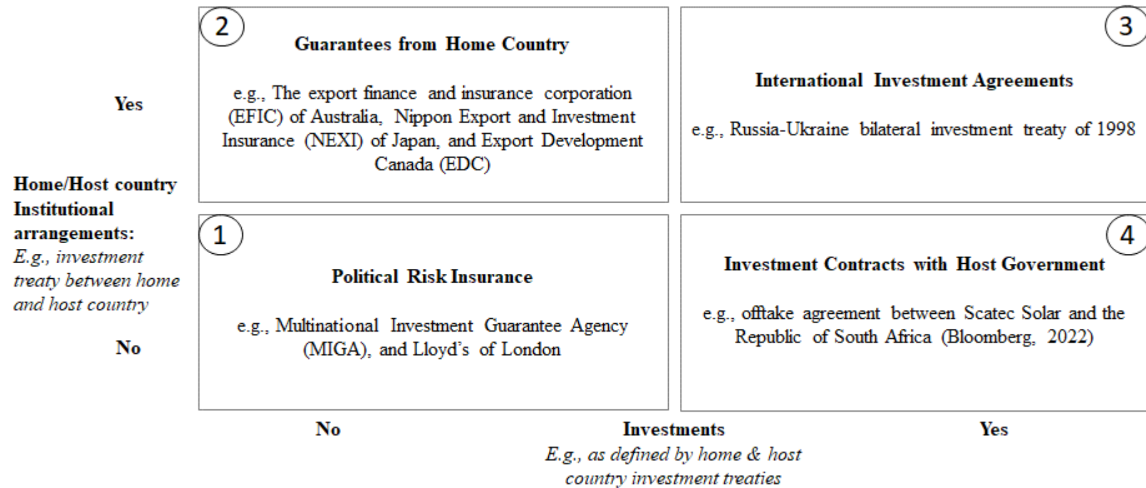


Figure 4: Stages of a typical MNC-host government dispute settlement process

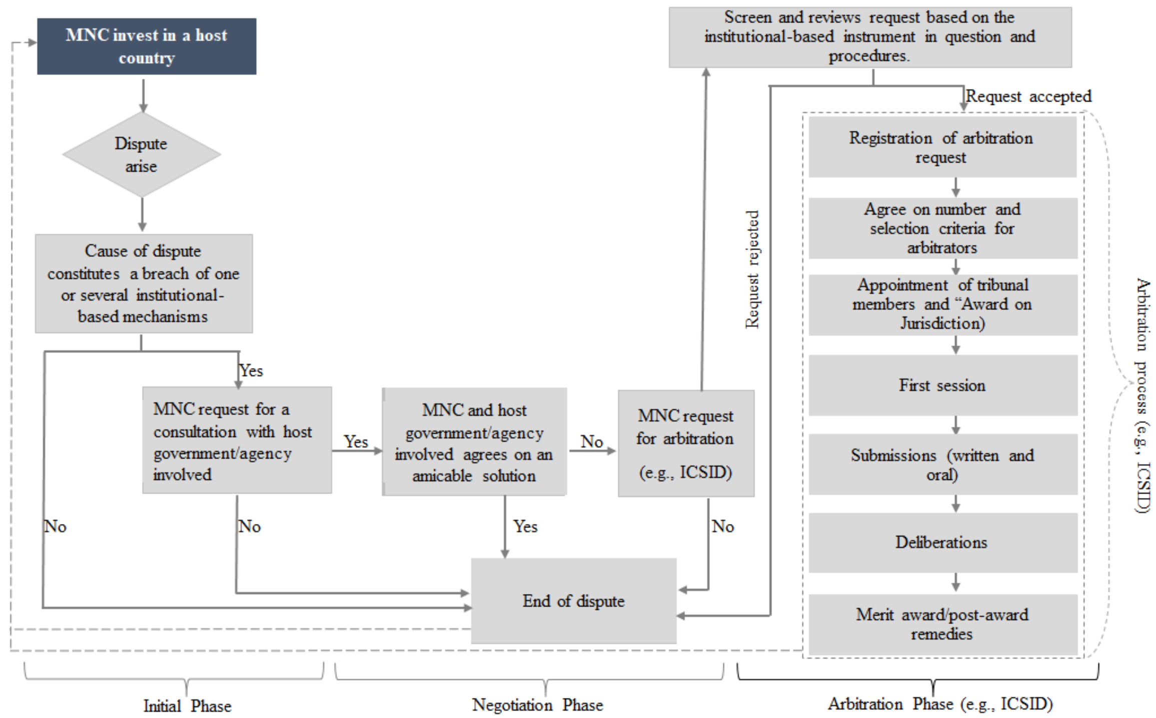


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Table 1: Number and value of arbitration awards (million USD), 1993 – 2019.

Year	Arbitration cases	Sum of arbitration awards (million USD)
1993	1	9
1994	2	2
1995	2	3
1996	6	1 011
1997	7	1 052
1998	11	166
1999	14	75
2000	13	10 114
2001	16	6 985
2002	25	1 671
2003	39	22 286
2004	42	8 698
2005	40	57 536
2006	27	23 443
2007	45	41 167
2008	39	5 394
2009	41	15 982
2010	36	14 350
2011	54	52 540
2012	55	46 173
2013	72	12 176
2014	60	11 750
2015	86	28 089
2016	77	44 914
2017	80	18 031
2018	86	27 433
2019	59	10 688
Total	**1 035**	**461 735**
Average award size (million USD)		17 027
Average award per case (million USD)		**432**

Source: Data from The World Bank's International Centre for Settlement of Investment Disputes (ICSID) (https://investmentpolicy.unctad.org/).

Table 2: A brief overview of institutional-based tools for curbing cost political risk cost.

Tools	**Definition**	**Main merit**	**Examples**	**Examples of empirical studies**
Investment treaties	Agreements negotiated among countries to promote and protect FDI in their territories, which give MNCs contractual rights to sue in case of expropriation	Offer prompt, adequate, and just compensation in case of expropriation – through external investor-state dispute settlement	Russian - Ukraine BIT (1998) The Energy Charter Treaty (ECT) Usage includes the case of Oschadbank v. Russian Federation (PCA Case No. 2016-14)	Albino-Pimentel et al. (2018); Allee and Peinhardt (2011); Jandhyala and Weiner (2014)
Investments contracts	Agreement between an MNC and government to regulate a specific project by the MNC	MNCs can bargain for special treatment and tailor contracts to their specific project needs	Contracts between Scatec Solar and the Republic of South Africa (Bloomberg, 2022)	Berger (2003); Gazzini and De Brabandere (2012); Maniruzzaman (2008); Von Walter (2015); Wellhausen (2015).
Political risk insurance	Insurance products designed to protect MNCs against specific political events	Compensation for political risks and their potential consequences, such as currency inconvertibility due to poor economic management	Multilateral Investment Guarantee Agency (MIGA-Convention, 1985); several private insurance companies, incl. Lloyds of London, Chubb.com, and AIG, *inter alia*	Arel-Bundock et al. (2020); Comeaux and Kinsella (1997); Jensen (2008); Moser et al. (2008); Peinhardt and Allee (2016); Yackee (2008b).
Investment guarantees	Guarantees provided by home governments to MNCs with the aim of promoting the external competitiveness of home country firms	Home government covers losses due to political risk abroad	Export Development Canada; Atradius Dutch State Business; Multilateral Investment Guarantee Agency (MIGA-Convention, 1985)	Choi et al. (2012); Gordon (2008).

i This refers to the Salini criteria, which are explained in detail in note iv.

ii USMCA replaced the North American Free Trade Agreement (NAFTA) on 1st July 2020.

iii Crimea became part of Russia after the Crimean status referendum of 2014. As such, all Russian treaties also covered Crimea.

iv We acknowledge that some arbitration cases are private; neither their filing nor resolution is public information.

v The Salini criteria developed out of a case between two Italian companies, Salini Costruttori and Italstrade, and their dispute with the Moroccan government (ICSID Case No Arb/00/04) (Decision on Jurisdiction, 23 July 2001) and has become the standard criteria for the tribunal to assess whether a foreign activity is an investment or not. Through a private company, the Moroccan government initiated a bidding process for constructing a 50-kilometer highway in Morocco. Salini Costruttori and Italstrade jointly submitted a bid and won the contract for the construction of the highway. However, the two companies did not complete the highway on time. Instead, they completed it 36 months later, going 4 months over the timetable laid out in their bid. The Moroccan government decided not to pay the full price because of the delay. After a series of domestic proceedings, the Italian companies submitted a dispute to ICSID arbitration under the Italy – Morocco BIT. The arbitration tribunal ruled that for the two companies to have made an investment in Morocco, there must be: (1) a contribution of money or assets; (2) a certain duration over which the project was to be implemented; (3) an element of risk; (4) a contribution to the host country's economy. The "Salini Test" has now become the main criteria for ICSID tribunals to determine whether an international activity is an investment or not. In a recent investment dispute case – Nova Scotia Power Incorporated v. the Bolivarian Republic of Venezuela (II) – the Bolivarian Republic of Venezuela terminated Nova Scotia Power Incorporated's right to receive up to 1.7 million metric tons of coal at fixed prices from the Paso Diablo coal mine in Venezuela. The tribunal relied on the "Salini Test" and ruled that Nova Scotia Power Incorporated had not made an "investment" in the Bolivarian Republic of Venezuela, thereby classifying their involvement as a portfolio activity.

vi There are already discussions that most of Ukraine's potential treaty breaches may be forgiven on the ground of "force majeure." For instance, the Ukrainian Chamber of Commerce and Industry has informed investors that the "military aggression of the Russian Federation against Ukraine, which led to the imposition of martial law," has evidenced "force majeure circumstances." Thus, setting the groundwork for a "force majeure" defense for MMCs' potential request for compensation against political risk costs due to the ongoing war.

vii Guarantees may also cover third-party losses, such as supplier default and political risk costs.

[viii] Tatneft v. Ukraine. Permanent Court of Arbitration (PCA) case number 2008-8. Please see https://www.italaw.com/cases/4736 for details.