MANAGING RISKS ACROSS BORDERS: A DYNAMIC ANALYTIC FRAMEWORK

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Investing Cross-border

- What kinds of additional risks does the investor in cross-border assets/ventures face?
  - Foreign exchange exposure: exchange rate movements cause a variance of outcome
  - Country risk: willingness/ability of foreign counterparty to fulfill terms of contract
- Foreign exchange risk can be hedged, but country risk has to be managed pro-actively

Country risk from sovereign defaults to institutional analysis

- Country risk management has evolved over the past three decades in parallel to the increased complexity of the global economic and financial relationships
- 1980s debt crisis focused on defaults by sovereign nations
- Following the 1997 Asian financial crisis, the focus shifted to institutional failure:
  - Multilateral institutions and industry associations moved to integrate institutional factors in the the development of a new international risk management framework
  - The focus on institutional factors broadened the application of country risk management from purely financial and emerging market focus to a broader focus-from country risk to international risk management

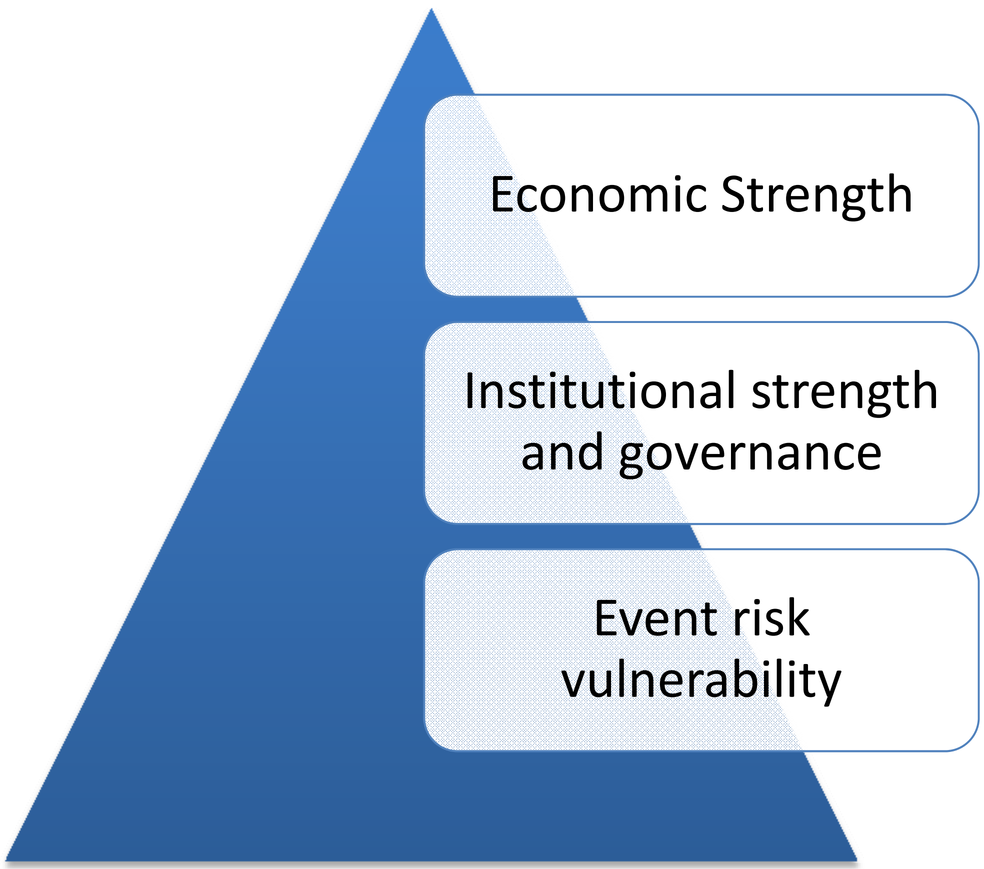
Country Risk-A Definition

- While country risk was initially focused on the probability of default on foreign currency debt by governments, the narrow definition has to be broadened to take into account the globalized economy’s complexities
- *From a holistic perspective, country risk should reflect the probability that events and conditions in a* ***country—including macroeconomic policy, internal and external economic, political or financial shocks, policy shifts and changes in the regulatory environment****—will interfere with, restrict or terminate the expected performance of financial assets in that country*

Country risk metrics

- Conventionally, country risk is reflected in a rating—letter or number—either externally (rating agencies) or internally generated by the MNCs/financial institutions
- These ratings initially was used to measure the probability of default on financial instruments, but has been extended to a short-hand measure of country risk
- While the ratings are broadly based on macroeconomic variables and scenarios, they increasingly incorporate measures of institutional risk, tied to governance structures—financial, regulatory/legal and corporate—and their evolution
- Country ratings are a key factor in development of international strategies as well as global allocation of capital to business activities

Elements of country risk assessment



Economic Strength

Macro-variables

- Very high

Macro-policies

- Moderate

Long-term trends

- Low

Institutional strengths and governance

Corporate governance
- Very high

Political/policy governance
- Moderate

Regulatory framework
- Low

Event risk vulnerability

Economic
- Very high

Political
- Moderate

Financial
- Low

Ratings Scale

AAA

- Exceptional economic, financial and institutional strengths to make payments disruption highly unlikely

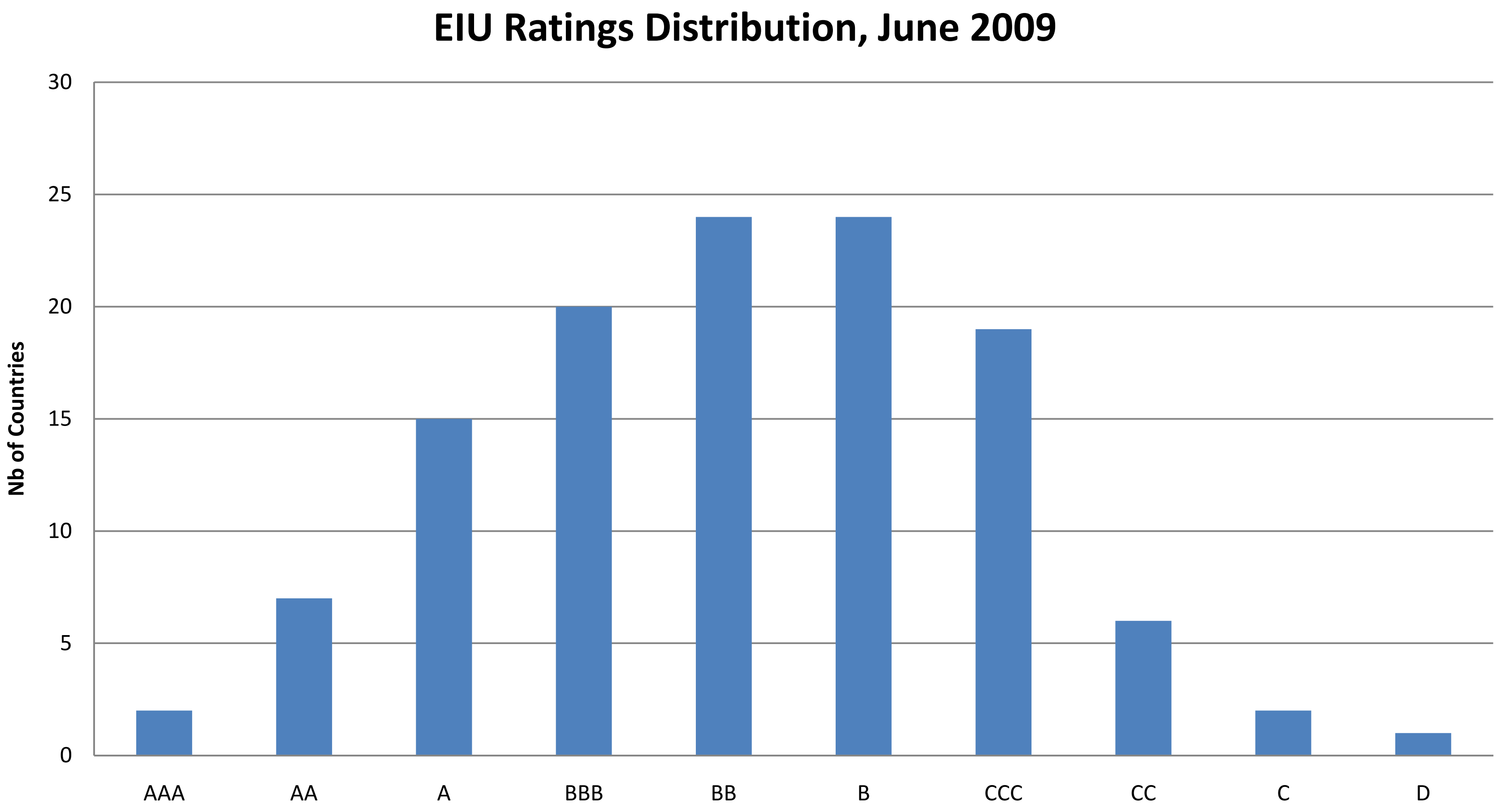
BBB

- Adequate economic, financial and institutional strengths to avoid medium-term economic/financial shocks

B

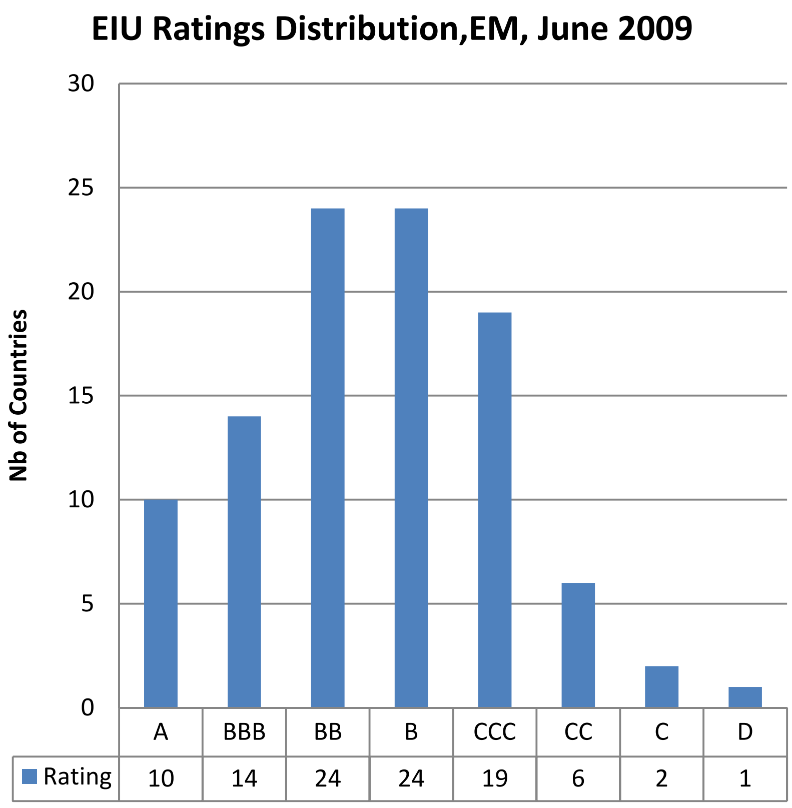
- One shock away from default

Global Ratings Map

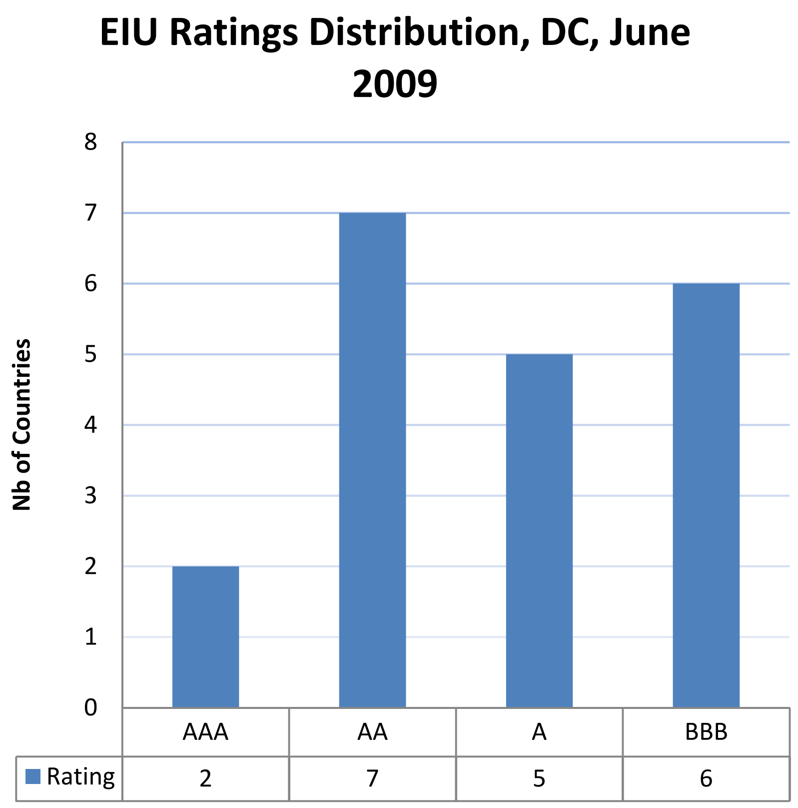


EIU regional ratings distribution

Emerging markets



Developed countries



INSTITUTIONAL FACTORS IN GLOBAL RISK MANAGEMENT

Institutional metrics

Macroeconomic and Data Transparency

- Data dissemination
- Monetary Policy transparency
- Fiscal Policy transparency

Institutional/Market Infrastructure

- Insolvency
- Accounting Standards
- Corporate Governance
- Auditing
- Anti-money Laundering
- Payment Systems

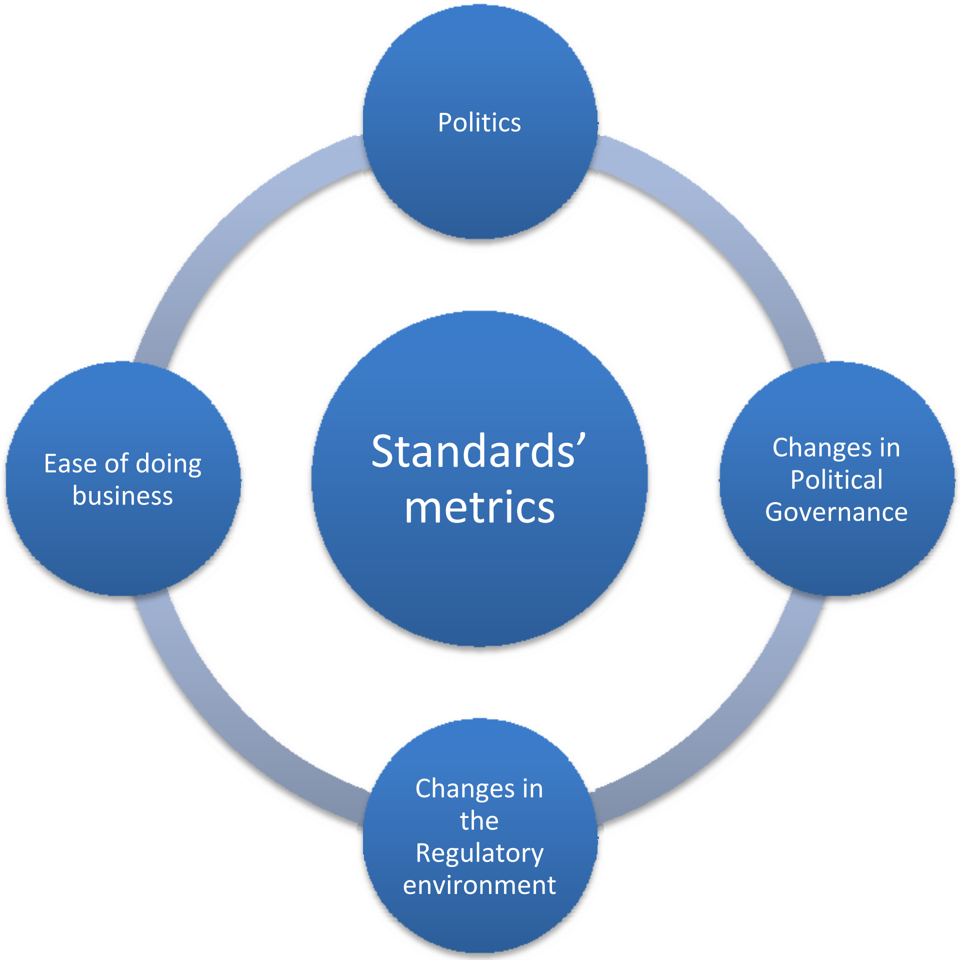
Financial Supervision/Regulation

- Banking
- Securities markets
- Insurance

Governance analytic framework

- Governance’s three dimensions: political decision-making context, quality of legal system and the regulatory framework
- Following the 1997 Asia financial crisis, emergence of a systematic framework from the work of the OECD, IMF, World Bank and international trade associations
- Focus was on financial markets, but adaptable to corporate environment

Dynamic risk management



Corporate governance defined

- "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."
  – *“Source: OECD”*

Corporate governance: the metrics

What to measure?

- The OECD Principles now consist of a set of 32 sub-principles organized into six broad categories, namely the (1) basis for an effective corporate governance framework, (2) rights of shareholders, (3) equitable treatment of shareholders, (4) role of stakeholders in corporate governance, (5) disclosure and transparency, and (6) responsibilities of the board.

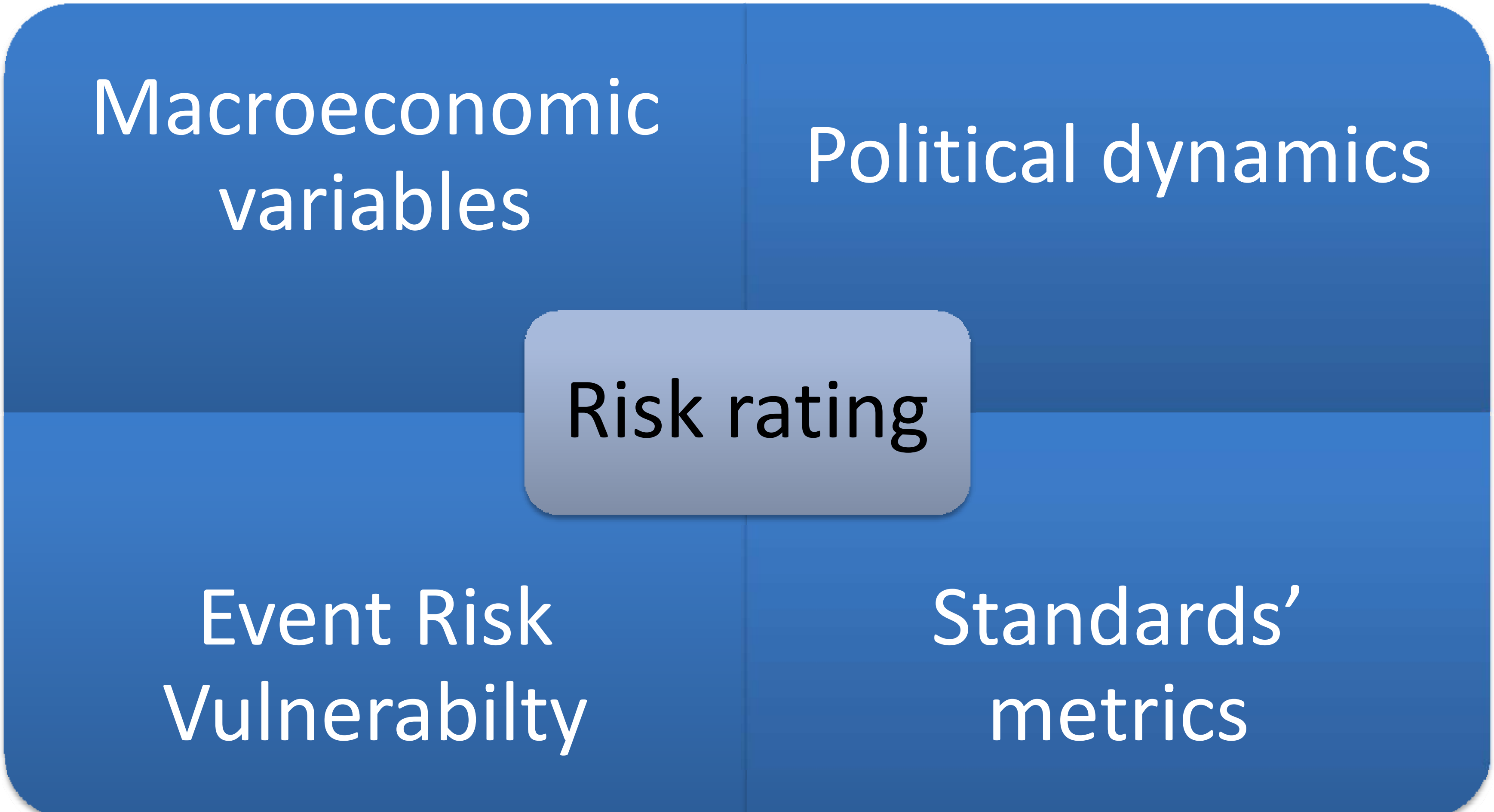
Sources

- OECD
- World Bank ROSC
- World Bank Ease of Doing Business Index
- Freedom House
- Transparency International
- World Economic Forum
- E-standards Forum

A model for dynamic global risk analysis: meta-ratings

- **Each of these indices may be useful in a specific way, but what is missing is an integrated approach to institutional risk.**
- **Meta Rating or Institutional Risk Index:** the methodology involves identifying the key underlying variables involved in measuring institutional risk, using existing methodologies and indices to measure them, and finally to combine them in a risk index
- The meta rating could be used by investors to complement the standard financial evaluation of international investments with an in-depth understanding of the country-specific institutional risks
- Such an analysis would apply equally to highly industrialized countries and emerging markets
- The methodology, which allows greater transparency, will give the investor a greater understanding of the process, as well as allow scenario building and probabilistic projections of the overall index

Meta-ratings



META RATINGS-A SIMPLE EXAMPLE

Meta-ratings 5 (best) to 1 (worse)

	S&P	WEF-FDI	WEF-GCI	TI-CPI	WB-DB	Corp Gov	**Total**
S.Africa	BBB+	3	4	3	5	3	**18**
Thailand	BBB+	3	4	3	5	3	**18**
Mexico	BBB+	3	3	4	4	3	**17**
India	BBB-	3	4	4	2	3	**16**
Turkey	BB-	3	3	4	3	3	**16**
Brazil	BBB-	3	3	4	2	3	**15**

Rankings

Rankings	WEF-FDI	WEF-GCI	TI-CPI	WB-DB	Corp Gov
S.Africa	6	5	6	5	6
India	6	4	2	1	6
Thailand	4	6	3	6	6
Turkey	3	1	2	3	6
Brazil	2	3	5	2	6
Mexico	1	2	4	4	6

S&P: Standard & Poors' Sovereign Rating
WEF-FDI: World Economic Forum Financial Development Index
WEF-GCI: World Economic Forum Global Competitiveness Index
WB-DB: World Bank Doing Business Index
TI-CPI: Transparency International Corruption Perception Index
Corp Gov: e-Standards Corporate Governance Metric

KARIM PAKRAVAN CONSULTING PROFILE

- **KARIM PAKRAVAN**
- GLOBAL STRATEGIST/ ASSOCIATE PROFESSOR (VIS.)
- DEPARTMENT OF FINANCE
- DE PAUL UNIVERSITY

- Background:
- 25-year career as a Senior Strategist in global financial markets, including foreign exchange research and international risk management. A recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture
- University of Chicago graduate (PhD, Economics)

- Key Competencies:
- Global foreign exchange markets
- Global macroeconomic
- Emerging markets
- Global risk management
- Geopolitical risk

KARIM PAKRAVAN CONSULTING PROFILE (CONT.)

How I can add value

Global Economics and Foreign Exchange

- Real-time analysis of global financial and economic developments
- FX markets analytics
- Fundamental research on global issues

Country Risk Management

- State-of-the-art country risk evaluation techniques
- Develop and implement global sovereign risk management strategies at the enterprise level
- Geopolitical analysis for the Middle East/Persian Gulf region

<u>Professional Experience:</u>

- Senior Faculty, Dept of Finance, DePaul University
- Chief Economist, Advocacy Investing
- Senior Economist and FX Strategist, JPMorgan
- Head, Country Risk Management, Bank One
- Head, Country Risk Management, First Chicago NBD

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