

A Practitioner's Guide to Effective Cross-Border Risk Analysis

Daniel Wagner



Managing Country Risk

A Practitioner's Guide to Effective Cross-Border Risk Analysis "Many important areas of modern finance lack that one solid, unbiased book that tells both the novice everything he or she needs to know about the subject, brings a coherent structure, and important, fresh insights to seasoned practitioners. Daniel Wagner has brought the world the go-to book on country risk analysis. *Managing Country Risk* provides a broad, deep, and accurately detailed analysis of country risk analysis tools and techniques in a volume unlike any I have read before. It is both timely and likely to enjoy a long shelf life."

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Peter Went, Vice President, Global Association of Risk Professionals Research Center

"Wagner carefully sorts through the fundamental principles of country risk management, adding context with examples from his quarter century as a political risk insurance underwriter, country risk manager, and advisor. The chapter on political risk insurance is the best comprehensive description of the product that I have seen. This book is an invaluable tool for the scholar and practitioner alike in understanding country risk and the techniques available to international investors and traders to address those risks."

Frederick E. Jenney, Partner, Project Finance & Development Group, Morrison & Foerster

"I found great value in Daniel Wagner's approach of combining 101 subject matter with graduate level country risk concepts, and was fascinated with the practical examples he used to drive the points home. I would think that this book would be of great value to a widely varied audience, including CEOs, CFOs, risk managers, directors of multinational boards, insurance underwriters and brokers, academics, and public sector practitioners."

Rod Morris, Vice President of Insurance, Overseas Private Investment Corporation

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Mark T. Williams, Executive-in-Resident/Master Lecturer, Boston University School of Management, and author of Uncontrolled Risk: The Lessons of Lehman Brothers and How Systemic Risk Can Still Bring Down the World Financial System

"This book is a marvelous exploration of a mind trained to integrate all information on all subjects into a coherent viewpoint that produces a business decision. After a long career practicing this kind of thinking in both the public and private sectors, Wagner's approach, and this book, are a treasure."

Dr. Paul Armington, President, World Institute for Leadership and Management in Africa

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CRC Press Taylor & Francis Group 6000 Broken Sound Parkway NW, Suite 300 Boca Raton, FL 33487-2742

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No claim to original U.S. Government works Version Date: 2011913

International Standard Book Number-13: 978-1-4665-0048-8 (eBook - PDF)

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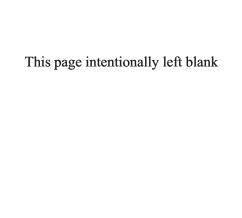
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I dedicate this book to my spouse, family, and friends, who have all been an incredible source of love and support over the years. Thank you for being there throughout the ongoing journey.



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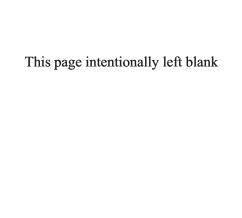
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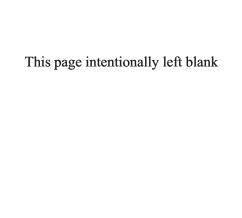
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Preface

Almost any event can increase a trader's, investor's, or lender's cross-border risk. An unexpected resignation, a terrorist act, or a currency collapse can completely transform the political and economic landscape of a country, a region, or the world. Since the advent of globalization, politics and economics have been forever entwined, sometimes resulting in calamitous outcomes. There have been several sobering examples over the past two decades, including the collapse of the Thai baht in 1997. The sudden and dramatic collapse of the Thai currency set off a chain of events that ultimately led to the economic meltdown of many of Asia's economies, resulted in the overthrow of the Indonesian government, and sent gyrations across the rest of the world.

One of the disadvantages of globalization and instant communications is that the impact of such change is felt instantaneously. Today there is less time to react before someone else does; we may be sleeping while others are reacting. Perhaps the impact of localized economic and political events would not be so dramatic if the international marketplace were not so interconnected—if currency and stock trading did not occur and information were not broadcast 24 hours per day. The trend toward seamless international financial transactions has continued at an even more breathtaking pace over the past decade.

One action or event that may be forecast to have a certain outcome at a certain point in time may end up having a completely different or unanticipated outcome years later. For example, when former US President Carter granted ownership of the Panama Canal to Panama in 1978, who would have imagined that, in 1999, when ownership was actually transferred, a Hong Kong company (Hutchison Whampoa) would spread enough money around the power brokers in Panama City to buy control over the ports at both ends of the canal? As a result, some would argue that China instantly gained the potential ability to influence the flow of global trade. On the flip side, by granting the concession to operate the ports to Hutchison, Panama, which has no national army, virtually guaranteed that US military influence would be present in the country for decades to come. This, in turn, will impact how future US military budgets are allocated and how US tax dollars are spent.

Consider also the impact that Turkey's possible accession to the European Union may have on Europe and beyond. Turkey has tried to join the EU for more than a decade, but strenuous objections from Greece and other members kept it from succeeding. Yet today, Turkey looks like the bastion of stability and conservatism compared to the economic "basket case" that Greece has become. Turkey and its political model—a pragmatic blend of civilian and military influence—have enormous political influence throughout the Arab world. What impact might the EU have in the Arab world today if Turkey had been admitted to the EU a decade ago? Today, Turkey is less interested in joining.

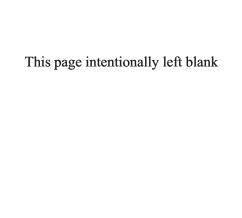
The impact of political change on businesses is as significant as it is on individuals—perhaps even more so. At stake are trillions of dollars of revenues derived from trading and investing abroad. For a business, the risks associated with political change are multifaceted. In general, an international investor often faces the risk of expropriation of assets when a new government takes power or an existing government adopts a negative orientation toward foreign investment. The risk of not being able to convert local currency into hard currency or to transfer hard currency out of a country because of a shortfall in the national foreign exchange supply or a change in law is ever present. And depending on where an investment is located within a country, the risk of damage to a facility or an interruption of business operations because of political violence can arise without warning.

For international traders, political risks are every bit as real. Imagine exporting goods to a government buyer only to discover after the fact that it has not been paying its bills, the United Nations has just imposed an embargo on the country, or your own government has just rescinded your export license. Cross-border partnerships can be unexpectedly tested as unanticipated events may unravel promising business prospects. These types of events happen all the time—even in times of peace. Political change only accentuates the political risks inherent in trading or investing abroad.

This book is about how to identify and manage the plethora of risks associated with conducting business abroad and how to think outside the box to be able to anticipate the impact of change on business operations. By reading this book, you will come to know more about country risk management than virtually all of your peers. You will also be able to add value to the risk management processes

in your organization, even if you are not formally part of a risk management unit. If doing so helps your organization become smarter about how it does business abroad and enhances its ability to make a profit, all the better, because in the process it will be contributing to development, job creation, and improving the lives of people around the world.

> **Daniel Wagner** Norwalk, Connecticut



Acknowledgments

Over the course of the past quarter-century I have worked with a lot of really talented people, a number of whom were particularly influential in helping me better understand the nature and practice of country risk management. In the realm of political risk insurance underwriting, Christophe Bellinger of the Asian Development Bank, John Hegeman of Chartis, and Christina Westholm-Schroder of Sovereign Risk Insurance provided unique working-level insight based on their own in-depth experience and perspective. Luis Dodero, formerly general counsel of the Multilateral Investment Guarantee Agency (MIGA), and Srilal Perera, formerly chief counsel of MIGA, enabled me to better appreciate the impact of legal and regulatory risk on cross-border investment. It was a privilege to work with each of them. I also want to thank the many individuals I worked with along the way who helped me learn so much about managing country risk while I lived and worked in Asia, Europe, and North America. Doing so enabled me to amass the knowledge I am now sharing in this book.

I want to thank Professor Alexis Papadopoulos of DePaul University, Professor Mark T. Williams of Boston University, and Mark Yim of GAMCO Investors for providing their insights and comments on a draft of this book.

xxvi Acknowledgments

Finally, I wish to thank everyone at Taylor and Francis, who has been a joy to work with. In particular, I wish to thank Kris Mednansky, who first embraced the book and has been a great source of support and guidance, as well as Judith Simon, the book's very capable and patient editor. Thanks for recognizing the book's potential to influence our ever-changing world and helping to make it a reality.

The Author



Daniel Wagner is the founder and CEO of Country Risk Solutions (CRS), a cross-border risk consultancy based in Connecticut, and Director of Global Strategy with Political Risk Services. Prior to founding CRS, Daniel was senior vice president of Country Risk at GE Energy Financial Services, where he was part of a team investing billions of dollars annually into global energy projects. Daniel was responsible for advising senior management on a variety of country risk-related issues, strategic planning, and portfolio management. He created a Center of Excellence for

country risk analysis in GE and led a team that produced a comprehensive automated country risk rating methodology.

He began his career underwriting political risk insurance (PRI) at American International Group (AIG) in New York and subsequently spent 5 years as guarantee officer for the Asia region at the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) in Washington, DC. During that time, he was responsible for underwriting PRI for projects in a dozen Asian countries. After serving as regional manager for political risks for Southeast Asia and greater China for AIG in Singapore, Daniel moved to Manila, Philippines, where he was guarantee and risk management advisor, political risk guarantee specialist, and senior

guarantees and syndications specialist for the Asian Development Bank's Office of Cofinancing Operations. Over the course of his career, Daniel has also held senior positions in the PRI brokerage business in London, Dallas, and Houston.

Daniel has published hundreds of articles on risk management and current affairs, is a nonresident scholar at the Institute for Near East and Gulf Military Analysis in Dubai, and a regular contributor to foreignpolicyjournal.com, *The Huffington Post*, and the International Risk Management Institute (IRMI). His editorials have been published in such notable newspapers as the *International Herald Tribune* and the *Wall Street Journal*. His first book, *Political Risk Insurance Guide*, was published by IRMI.

Daniel holds master's degrees in international relations from the University of Chicago and in international management from the American Graduate School of International Management (Thunderbird) in Phoenix. Daniel received his bachelor's degree in political science from Richmond College in London. He can be reached at daniel.wagner@countryrisksolutions.com or through www.countryrisksolutions.com.

Abbreviations

ADB Asian Development Bank

AID Agency for International Development (of the United States)

AIG American International Group

ASEAN Association of Southeast Asian Nations

BCA Brazil Cooperation Agency
BI Business Interruption

BIS Bank for International Settlements
BMI Business Monitor International
BRIC Brazil, Russia, India, China

BRICS Brazil, Russia, India, China, South Africa

CCP Chinese Communist Party
CDB China Development Bank

CEND Confiscation, expropriation, nationalization, deprivation

CF Contract frustration

CI Currency inconvertibility/nontransfer
CIRC China Insurance Regulatory Commission
CNOOC China National Offshore Corporation
CNPC China National Petroleum Corporation

EBRD European Bank for Reconstruction and Development

ECA Export Credit Agency

ECGD Export Credit Guarantee Department (of the United Kingdom)