

# INVESTMENT GUARANTEES

## - MANAGING THE RISKS OF FOREIGN DIRECT INVESTMENTS

Are you familiar with Murphy's laws? Then it will not come as a surprise to you that there is an element of risk in any entrepreneurial activity. In recent years risk and risk management have therefore become widely used buzzwords.

As a consequence of new legal requirements stipulated in the German KonTraG many companies have started to ask themselves: How do we handle the risks of doing business? The German KonTraG explicitly demands adherence from public limited companies only though a small part of its content also applies to private limited companies.

### **Murphy's Laws**

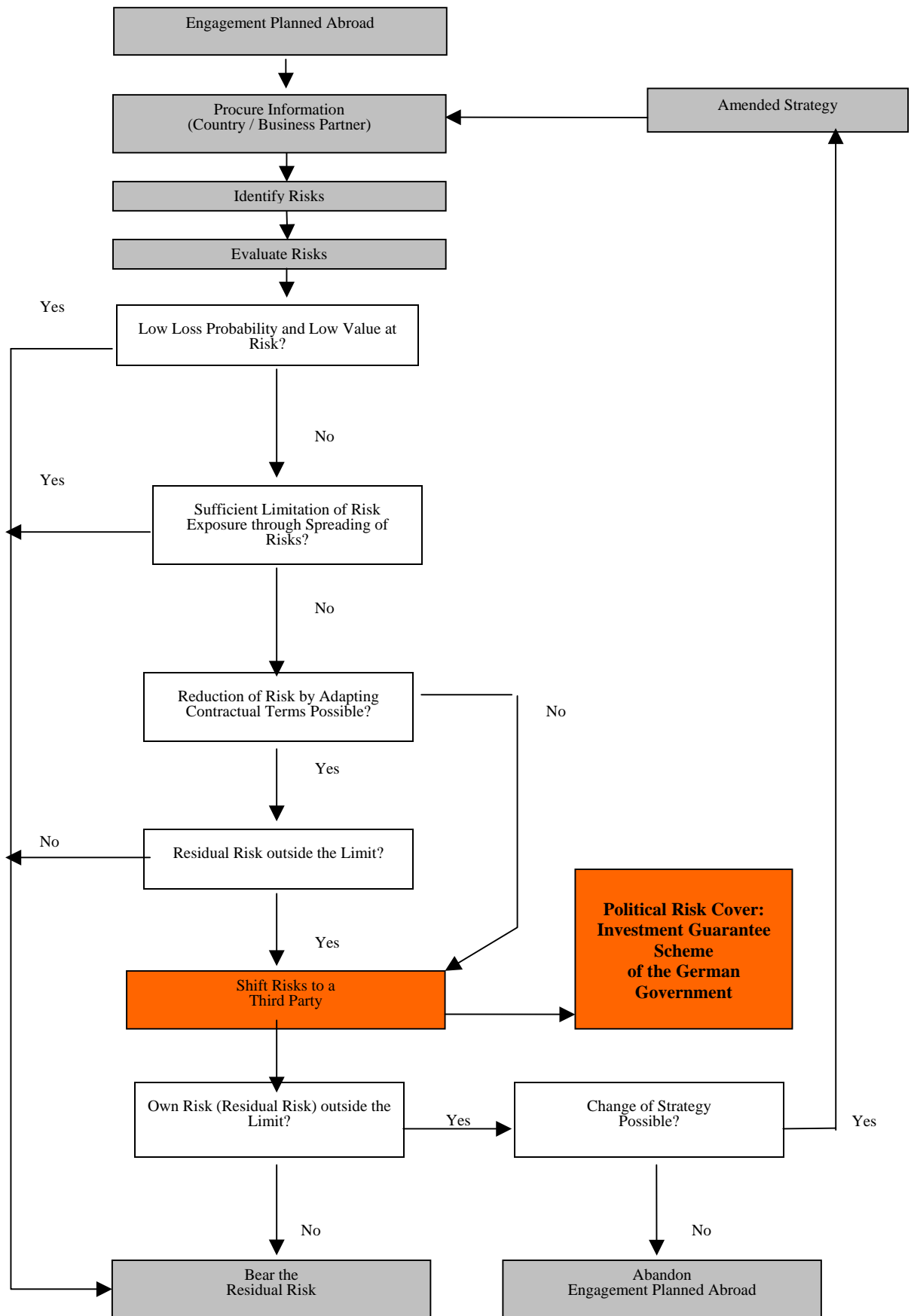
#### **Author's choice**

Anything that can go wrong will go wrong.

Left to themselves, things tend to go from bad to worse.

If there is a possibility of several things going wrong, the one that will cause the most damage will be the one to go wrong.

## Graphic Presentation of the Decision Making Process



By introducing the KonTraG legislators were aiming at ensuring that companies - above all public companies, which represent shareholders investments - develop structures of corporate governance which provide for early warnings and the awareness of possible future emergencies. The extra time available for a timely and adequate reaction to crises is expected to help limit losses or even prevent an eventual collapse.

However, shareholders are not the only ones with a vital interest in limiting losses and preventing collapse. Every entrepreneur will be trying to prevent such events from happening. Therefore uncovering the risks of one's own business and developing a strategy how to handle them is a necessity.

Of course, we lack the power to suspend Murphy's laws but the following suggestions should make life with them at least a little more calculable.

Hoping to offer some useful hints on how to manage risk we prepared a **graphic presentation** of the decision-making process regarding a planned entrepreneurial activity abroad.

## **I. Entrepreneurial Activity Abroad**

The special element of risk in doing business abroad is the difference between the business environment, one is used to from home and the rather different rules and regulations in the host country. Such risks may threaten the economic survival of the whole company.

Political and legal developments at home can be incorporated in business plans because of longstanding experience what changes to expect from them. But in foreign countries such developments may lead to unexpected and surprising changes in the business environment. An important aspect of insecurity experienced by people doing business in a foreign country are difficulties in really understanding their local partners. These difficulties often stem from differences between the partners in culture and mentality. Deficits in being aware of such differences and knowing the country and its people are a major hurdle in successfully engaging in foreign trade.

Additional skills are needed for making a foreign investment a success. First of all the prospective partners have to find a common language. Knowledge of the native language in the host country is an advantage and an important step

towards overcoming the difficulties in understanding each other's intentions. Finding out as much as possible about the business environment, the legal system and the political conditions is a necessity. If this knowledge is not yet available in the company, a decision has to be made on how to acquire it. Should additional staff with corresponding skills be hired? Can present staff be trained accordingly? Is a locally based consultant the best choice?

There is usually a substantial amount of cost attached to the acquisition of specialized knowledge. In case of a failure justifying this cost on top of the losses incurred may be very difficult. It is more than justified to have a critical look at risks when contemplating a foreign direct investment, especially when dealing with developing, emerging and transition countries.

## **1. Country Risk**

### ***a. Political Risk***

The term political risk covers all dangers to foreign direct investments which may arise from the political environment or government intervention in business matters.

Such dangers - to name some recent developments - may be national over-indebtedness of the host country and consequently moratoriums or delayed payments and transfers of loan repayments, dividends and interest.

Also sovereign acts like nationalization and expropriation (including sovereign acts which in their effects are similar to expropriation) are political risks.

Another category of government action (or inaction) which is fast gaining importance in the growing field of public-private partnerships is the danger of breach of contract by the government or other entities controlled or directed by the government in the host country. A breach of legally binding commitments, on which the economics of a project are founded, is clearly a political risk. Take for example the current situation in Argentina: Public utilities privatized in recent years have been prevented from fixing their rates in US dollar as stipulated in the contracts and are now forced to accept local currency. At the same time the government ruled out an adjustment of the rates for the depreciation of the local currency.

Included in political risk are war, revolution, civil disturbance or other armed conflicts in the host country. Such outbreaks of violence may lead to

destruction, damage or confiscation of plant and property. In this context the events in former Yugoslavia automatically spring to mind.

It is essential to take into account political risk when evaluating business opportunities especially in developing and transition countries. Ignoring such dangers might prove a costly omission.

### ***b. Foreign Market***

A further challenge is to procure the necessary information about a foreign market. Key to success is not only broad knowledge of rules and regulations, such as export, import, price and foreign exchange regulations, but also the awareness of different cultures leading to differences in business customs which may seem rather strange from a foreigner's point of view. Respect for native rituals and expressions of courtesy as well as observing the hierarchy can be decisive for the success or failure in building-up a business relationship, especially in Asian countries. But even in Europe customs in business life do vary greatly. For example there is quite a difference between the north and the south in the concept of time and daily schedule.

Moreover, potential business partners and competitors have to be identified and the market chances have to be assessed realistically. New media provide easier access to the information needed. The Federal Republic of Germany, for example, offers advice for foreign trade via internet through the Bundesagentur für Außenwirtschaft (bfai). Information on country or trade may be downloaded whenever the need arises.

Another challenge is to find the right way for advertising the product in the host country. Differences in language, culture, attitude and habits of consumers may require a change or even a complete rethink of marketing strategies developed for the home market. Hiring local talent should be an advantage.

### ***c. Credit Risk***

Credit risk arises from the inability or reluctance of the debtor to honour his debt. This standard risk for all domestic credit transactions is intensified when dealing with a foreign borrower or partner. Assessing and controlling the creditworthiness of business partners is complicated by distance, language barriers and related costs. Further complications arise if the claim has to be collected through the courts. The lack of an universally accepted international

business law leads to differing opinions on which law should be applied in case of litigation. Stipulating a place of jurisdiction in the contract is the usual remedy for this problem. If the parties agree on the host country as the place of jurisdiction, the legal process and the legal situation may differ from that in the home country. Even wilful discrimination against foreign parties to an action is possible. On the other hand, with Germany as the place of jurisdiction it can be very difficult to enforce final judgements in the host country.

Assessing the future development of the foreign exchange rate and thus the risk of alterations for contracts concluded in foreign currency is a difficulty for many investors. The economics of planned investments and the projected earnings depend on the foreign exchange rate used for the initial calculation. A devaluation of the foreign currency during the contract period will cause a drop in earnings or losses. The foreign exchange rates of freely convertible currencies fluctuate daily. Moreover, governments may surprise the market with a sudden devaluation of their currency by introducing a fixed rate. More often than not, the actual foreign exchange rate used for settlement will differ from the rate used for calculation. Therefore one has to take precautions against such deviations.

For contracts with a fixed payment schedule these precautions may be taken in the form of hedging. A hedge is an agreement with a bank to exchange foreign currency for local currency on payment day for a previously fixed rate including a premium for the bank.

## **2. Financing**

In foreign business granting generous loan repayment periods and providing financing for plant construction emerged as major factors for winning customers. Quite a few contracts never reach the financial close because the parties are unable to secure adequate financing.

The low equity cover of many German companies means that a financing without the help of banks is usually out of the question. Financing from the cash returns of other activities is seldom possible because the money flow can only in exceptional cases be directed in such a way that the timing of earnings influx is co-ordinated with expenditure outflow. Thus investors often depend on third-party financing.

In this context German banks are criticized for their conservative approach to lending. This seems only partially justified. Since banks finance their lending through the deposits of their customers, their intention and obligation is to only take calculable risks. The necessity to write off a lot of bad debts would endanger the confidence of customers and spell trouble for the bank itself.

The German Government offers assistance in financing investments via the various credit programmes of the Kreditanstalt für Wiederaufbau (KfW). Foreign investments may be eligible for the KfW Programme for SMEs Abroad, the KfW Environmental Protection Programme Abroad or the export and project financing facilities of the KfW. On offer are long-term credit facilities with low fixed-interest rates giving investors a sound calculation basis.

### **3. Risk Coverage for Investments**

Investment insurance offers the investor protection against infringement of his rights as an investor, his claims and property rights.

Such coverage is particularly important for the most frequent political risks since the realization of a particular risk may hardly be anticipated and it is usually beyond the power of any individual company to influence the cause for such a risk. The investment guarantee scheme of the German Government offers German investors "packaged" protection against the incalculable consequences of political risks.

The major part of the underwriting volume refers to projects in developing and emerging countries as well as former state-trading countries because overall political risk is deemed to be very high and difficult to estimate in those countries. Another advantage of the investment guarantee scheme is that early Government intervention to safeguard the interests of policy holders in a developing conflict can avoid impending losses. For SMEs government backing provides the necessary security for engaging in business abroad.

## **II. Basic Steps towards Introducing a Risk Management System**

The first step on the road to a risk management system is formulating and writing down the **risk strategy** of the company. Most companies have developed a customary way - a tacit strategy - of dealing with the risks of doing business. Based on this, the requirements for a risk management system can be determined.

The next step is to **identify all risks** which may arise in the company during the process of producing goods and services. This first analysis of possible risks usually takes quite a long time but only if the "right" risks are managed risk management can contribute to securing the bottom line of the company. A well-established method is to follow goods and services step by step through all production stages, from accepting the order until receiving the final payment in order to define the related risks likely to hamper and/or prevent the successful conclusion of the process.

Depending on the size of the company additional methods used for identifying potential risks are centrally prepared check lists, indicator screening/early warning signals, risk workshops or team brainstorming sessions.

It is important to take into account that the relevance of certain risks may vary because the business environment and the production process will most certainly change in the course of time. Therefore, regularly checking the results of the first risk analysis for necessary changes should be an integral part of risk management.

After identifying all possible risks they should be closely inspected and evaluated. Not all risks are equally relevant for the economic survival of the company nor is their realization equally probable. Risk management therefore means a **risk evaluation**, i.e. in how far risks influence developments decisive for the economic future of the company.

There are various ways to come to such an evaluation. Among them complex mathematical models to deduce probability functions, expert systems based on experience and rankings (ratings). Often a quantification of risk is impossible because necessary information is not available. Instead qualitative elements are defined for achieving a systematic classification of risk.

A division of risks into different classes is the most common approach. Based on experience and expertise risks are classified according to expected probability and potential damage, thus creating various risk groups. The precautions already taken, possibilities for further protection and interrelations between risks as well as their concentration have to be combined in a suitable classification.

For instance country risk is usually evaluated by comparing the overall situation of various countries. Today there are many published country ratings prepared by rating agencies and others. Well-known and widely respected are the OECD

Country Rating, BRS - Business Risk Service, Institutional Investor Country Credit Rating and the Euromoney Index.

**Risk controlling** follows the evaluation of risk. Keeping the risk strategy of the company and the individual risk value firmly in mind, a decision must be made on the volume and method of providing for risks. The basic question is:

Which overall volume of risk is acceptable for the company? This overall risk limit has to be divided into limits for the individual classes of risk. If any limit is exceeded, action has to be taken. Four different ways of influencing the exposure are open to the risk controller:

1. forego all activity with unacceptable risks,
2. bear the risk on one's own,
3. limit the risk by measures of loss prevention,
4. shift the risk to third parties by insurance or guarantees.

An important guideline for shaping the risk management system of the company is: which amount of damage is endangering the company so that immediate action has to be taken? Being prepared for such events and having the response to crises is an essential prerequisite of effective risk management.

The findings from the evaluation stage are only a snapshot of the current risk exposure of the company. To stay ahead of changes in the business environment, guidelines and strategies have to be developed for handling new or changing risks. The necessary basis for an effective control of risk in the context of a risk management system is the continuous **supervision** of risks.

Critical element of any risk management system is therefore the permanent flow of information regarding the current status and changes in the value of any given risk. Rules and regulations should be established on how to **communicate** and **report risk** exposure within the company. First signs of a change usually appear on the operative level of the company. Immediate reporting of risks threatening the success of the company to the decision-makers must be guaranteed for enabling them to react promptly. Thus the central task of the risk management system can be fulfilled.

Clearly defined reporting structures and responsibilities have to be introduced. Based on the information gained from the risk management system a responsible

company leadership will always be able to initiate the planned action to avoid further problems.