

Sovereign risk re-defined: A new analysis of an old dilemma

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“...So they [in Government] go on in strange paradox, decided only to be undecided, resolved to be irresolute, adamant for drift, solid for fluidity, all-powerful to be impotent...”

Sir Winston Churchill
The Hansard, November, 1936

The new world stage – an era of compliance

“...Our world has just changed, and our economy will certainly shift with it, in just a few days, our lives too will be different - quickly, let's get to work...”

I am reminded of these words purportedly uttered by the Marquis de Condorcet, the celebrated French economist, mathematician and philosopher of the Enlightenment, upon hearing the news that the French Revolution was well under way.

It is very clear to all of us that this “shift in living” also occurred on the 11 September 2001. On that day, our whole world changed for ever, and we were transformed almost without noticing, and just about everything, including the manner in which we conduct business, practice our chosen professions, invest, travel, and even how and when we go on holidays, would never be the same again. Our world today is a very different place than it was than just mere three or four years ago. For example, although many governments and supra-national organisations were already moving towards more stern requirements for uniform tax and revenue collection and corporate financial compliance, the 9-11 terrorist assault on America, and the subsequent, but rather, quickly-declared War on Terrorism, swiftly unified all efforts around the globe to fight the war on terror in all fronts. The White House recently stated

that over ninety countries have now joined the war on terror, whether militarily, in the sharing of intelligence, or in policy formation.

Almost immediately, the law-makers of the world reacted. In the US that same year, the Congress hastily passed the USA Patriot Act, the Homeland Security Act, and recently, the Domestic Security Enhancement Act of 2003, which is at times referred to as The Patriot Act II. Various countries such as the UK, where the Anti-Terrorism, Security and Crime Act was passed that same year, and in many others around the world, such as Germany, Canada, Peru, Australia, France, Spain, India, and the 15-member nations of the EU, have now approved similar measures, in a rush to secure their borders, the integrity of their financial and capital markets, as well improve their overall economic and national security.

This legislation places more pressure for disclosure, compliance, liability, vigilance, and adherence, on the part of investors, institutions and companies. Furthermore, certain professionals such as accountants, lawyers, bankers, investment advisors, etc., are now bound to be more watchful of “suspicious” activities and clients, and are under a higher duty and obligation to report such activities to the proper authorities.

The impact of September 11, compounded with the recent corporate scandals such as Enron, Arthur Andersen, MCI WorldCom, Martha Stewart, Parmalat, Deutscher Bank, and even some New York Stock Exchange executives has forced governments to re-examine the financial markets, corporate governance, and compliance laws, which now permeates the Global marketplace and its participants. As a result, the Oxley-Sarbanes Act 2002

designed to ensure corporate financial compliance and responsibility was passed in the US, along with similar legislative measures in other countries such as the UK, Italy, Germany, etc.

Aside from the military and law enforcement, no other area or segment of life has been more affected by these events than the international financial and economic world. We must therefore expand and redefine our understanding of the concept of what was classically known as “Sovereign Risk” in international investments and global trade.

With so many new compliance regulations being ratified around the world, which are presently re-shaping the global marketplace, how we do business in the arenas of domestic and international investments, the global banking structure, the several capital, financial, securities and commodities markets, as well as the currency exchange system, and even global trade, the sovereign (or government) risk analysis must be expanded and redefined to include “compliance” as a higher legal risk.

It is government that promulgates these laws, and compel us to keep-up and adhere to this ever-changing, endless web of legal, financial, and economic rules which not only burden the global investors, but may actually stifle their efforts to reap the maximum benefits of a greater “return” from a global or (well-balanced) international portfolio, whilst increasing the cost of doing business.

Then, there is taxation. Transparency and strict compliance with all rules and regulations are no longer merely passive requirements; it is now an absolute necessity and essential for the operational survival of all investors, companies and organisations that partake in

global business, trade and investing. Such is the rule and the order of our day.

A new proposition with a modern perspective

Although the term “sovereign risk” has traditionally been used more interchangeably with the term “country risk,” today more than ever sovereign risk is more exact and it applies more precisely than in the past. Governments are rapidly implementing vast amounts of new legislation aimed specifically at combating financial support of terrorist organisations, and other organised crime related activities. Today, the emphasis is on fighting money laundering, the deterrence of tax evasion, reduction of harmful tax competition worldwide, etc.

Last year, I outlined in this Journal, the necessity for the modern international investor to be aware of various types of risks that are involved in international and “offshore” investing, as well as how to identify, balance, and use risk as an ally, in order to obtain optimum profit return, and increase portfolio performance across markets. Nevertheless, keeping in mind our current reality, and the contentions made above, we must now take a fresh look at sovereign / country risk, and re-examine its new significance for the global or offshore investor today.

To place the concept of risk in perspective again, I must mention that investors should always remember that risk is a natural and inherent element of all investing, and that risk tolerance and aversion are important factors to consider in investment planning and strategies. Further, I must also remind the reader that there are many other types of inherent risks in the market, such as: financial and credit risks, specific market or industry risks, liquidity risks, institutional risks, interest rate risks, etc. Although independent and individual investors in the past did worry to some extent about sovereign risk, it was mostly seen as an institutional and/or corporate concern, especially during strategic market development or in business expansion planning, etc.

Traditionally speaking, sovereign risk is defined as “that risk incurred by a company or individual in a foreign (business) environment, or in a host country where changes in government (or industry) policy can occur unexpectedly, and turn against the

interest and property rights of a foreign company or investor”. Exposure to such risk will most surely result in uncertain and unstable investment consequences for companies and individuals, as they face the peril of property and asset confiscation, expropriation, forfeiture, nationalisation of assets and land, and the ever-lurking menace of the funds, profit, and assets “freezing”. In addition there is the uncertainty of a compliance requisite, or some policy shift within the internal (national) political infrastructure, or even perhaps, in the military sector. It is therefore necessary for an international investor, whether institutional or private, to research and prepare a well-rounded strategic investment plan that not only assesses the types of market risk listed above, and to understand all the risks involved when shifting to a either an international or global portfolio, including “sovereign risk”.

By understanding such a spread of risk, the global investor is much better informed and prepared to avoid loss and hence offset any risk that may arise as a result of sudden changes in any country, or regional shifts in policy - economic, political, military, legal or social. After conducting research, investors may then be able to organise a “contingency” plan, in cooperation with their respective investment advisors or other professionals, so that they may act quickly on their behalf, should such events occur. Of course, investors should always be vigilant of risky national situations and regional conflicts, wherever they may hold assets or property interests, including intellectual property rights, and be ready to act in a moment's notice, and transfer their holdings elsewhere.

Examples of such contingency plans include a “Flee or Fleeing” Clause in a Trust; a specific contract provision regarding payments, even an investment agreement or money market account that would be (preferably) placed with an international bank with offices around the world; a “reciprocal / transferable” term account with an international investment firm; or a letter, affidavit, or power of attorney between bankers, legal, accounting and financial professionals, empowering them to cooperate in the investor's absence, or if she/he is incapacitated in some way. Investors may even make use of certain international letters of credit that may be arranged and

negotiated, as a “stand-by” solution for some commercial or investment purposes. There are numerous other methods used to organise such preventive measures and transfer-action plans that can be very effective whenever such exigent circumstances arise, as these situations are often unpredictable, and some cannot be foreseen, until it is too late, if the investor is unprepared. It is often said that “chance always favours the prepared mind”. This is a fine example of that old adage.

This type of risk assessment is paramount for both individuals and companies, as they always seek to participate in stable and more predictable markets. Conversely, this type of risk, when met unprepared, may also serve as the reaffirmation of an investor's apprehension and worse foreign market fears, which in turn, will keep some investors out of developing markets and regional market participation.

In the past, the two most significant factors in sovereign or country risk were that of political risk (described above) and financial or economic risk, which are interrelated, and refer to the unanticipated events in a country's economic, financial, industry or business life, which may adversely affect its currency exchange value, capital markets, and international economic or trade policy, etc. In this new era of far-reaching regulatory and compliance requirements, we must expand the traditional definition of sovereign risk, and add a new component or category; that of “compliance and regulatory” risk, which is of course, a legal- type risk. It is a “high level” risk and one by which a “plea” of ignorance or unfamiliarity with foreign laws will not be tolerated or recognised, as governments stand to profit from forfeitures and asset seizures, whether with or without “due process” of law.

Perhaps, the two simple equations shown below, can serve to illustrate the assertion more precisely. The most two significant constants here are “risk” and “change”. As in economic analysis, these two are represented by the Greek letters Beta (β) for risk and Delta (Δ) for change. S/C symbolise sovereign and country risk, P stands for politics, F_e for financial and economic risk, and Pi (π) policy. The first illustration represents the traditional concept, or the status quo, whereas, in the second illustration, one can see that the factor

of politics has been enhanced by C1, the cultural factor, and also by C2, which is the compliance/legal (regulatory) factor, represented by the Greek letter lambda (λ).

In the past, the sovereign / country risk equation could be illustrated as:

$$S/CB = \frac{P + F_e}{\Delta(\pi)}$$

Today, however, sovereign and country risk assessment must be extended not only to include cultural (and regional) risks, such as in the case of Islamic or Arab nations, the Latin American community, Mercosur countries, or even the European Union, but also whenever countries act jointly, as they may be influenced by the same or similar policy shifts in trade, commerce, diplomacy, and foreign or economic policy, etc. Therefore, the equation below precisely characterises that in today's world, we must measure and expand sovereign risk to include, not only political and financial risks, but also include and balance these elements against economic, cultural, compliance/ legal risks, that may present a high level of intolerance of legal responsibility and financial liability.

Therefore, today's assessment of sovereign risk should be:

$$S/CB = \frac{PC1 + F_e + C2(\lambda)}{\Delta(\pi)}$$

Sovereign Risk assessment has been used for many years by multinational companies, banks, and global investors as an index or indicator of each country's or region's risk of investment, their credit and fiscal rating (or macro- risks), their inflation and interest rates, their ability to repay private or public loans, future "cash-flow" structures, market expansion plans, and more importantly, changes to investment portfolios and their required return on investment.

For many years, economists, institutional investors, and corporations have been employing various devices that can effectively measure and diminish sovereign risk per country and region. Examples of these are the International Country Risk Guides, Economic and Country Intelligence Reports, provided by services such as Control Risks Information Services (CRIS), The Economist Intelligence Unit (EIU), Moody's Investor Services, Political Risk Services, Euromoney Reports, Bank of American Country Reports, Standard & Poor's Rating Group, and many other rating

services. There are also government related public reports that are usually available through each country's Ministry or Department of Commerce or Foreign Affairs, and some governments even publish intelligence reports on particular countries, which are now available on the internet.

These reports are not only useful for Sovereign Risk assessment, but also for spotting positive and affirmative changes and opportunities for profit and market participation around the world. Just as there are negative and harmful policy shifts for investors, there are constructive and beneficial ones that can create endless prospects in new emerging and developing markets for the shrewd and alert global investor. Moreover, investors should also be aware that political risk insurance is also available from many top international insurance companies and government export credit agencies, as well as from the World Bank, and other international organisations.

Another important tool that is often used in comparing risk ratings among countries, and their comparative spread, is called the Foreign Investment Risk Matrix, or the FIRM approach. This is another excellent method introduced by economists in the 1960s exclusively for foreign risk evaluation and modelling that can be very effective. It is especially efficient when designed correctly and realistically and when presenting all quantitative factors and development trends within countries. Its rating extends from the "acceptable" to the "unacceptable" risks levels, and it incorporates countries in the unpredictable and/or "unclear zones" rating, which can present the investor with factual decision-making considerations and real choices of action.

Conclusion

As our global economic reality continues to change at a formidable pace, all investors must keep up with the economic and political transformation, which also assimilates the cultural, social, and regulatory or legal shifts that will directly impact the investor, its profit margin, expected rates of return, the portfolio asset mix, market volatility, and may even involve the potential of revocation of property rights, and the

confiscation of assets. Consequently, investors must become vigilant and work diligently with the appropriate skilled professionals that can help them to avoid risk and loss, as well as to optimise their investment profit performance. By becoming better informed regarding all kinds of risk, investors are now better prepared to deal effectively with the planning, structuring, and tactical outcome of their international investments. Hence, they can become better educated about the limitless opportunities that abound in strategic asset allocation and market diversity. In my opinion, that is the true character and nature of a modern "global" investor, whether private or institutional.

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