

RISK MANAGEMENT

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Global shocks put focus on resilience

Paul J Davies explains how companies minimise hazards as they are drawn to areas with greater rewards – and danger

When Asia was engulfed in a currency crisis in 1997, western banks and many other companies and investors pulled back from the region rapidly – and sometimes completely. In the wake of this century's financial crisis, many were predicting if not the end of globalisation, then certainly a substantial interruption and an era of protectionism. But in spite of tensions over trade and financial bail-outs, and even in spite of political crises and natural disasters, this has signally failed to take place.

"The incentive to invest in emerging markets remains strong," says Nick Robson, an international risk expert at JLT, the insurance brokers. "In 1997, banks and others simply pulled out of Asia in response to the currency crises. But at that time there was plenty still to do in their home economies, which were booming."

Melvin Glapion, managing director of business intelligence in the UK for risk consultancy Kroll, agrees. "The overall picture in terms of globalisation is that there is no choice – growth looks anaemic at home, so that's going to push us into more emerging markets," he says. "These may be more interesting markets, but they can also often be more corrupt and uncertain markets."

The sources companies normally rely on for information are not the same, says Mr Glapion. "There is often no free press, few equity analysts, limited public record. You need to be talking to people on the ground, generating your own contacts and sources of information."

People also do not focus on how much connection there is between government and industry, and who really exerts control. "If you look at Transparency International, the involvement of western companies has not had any real impact on the level of corruption in many countries," Mr Glapion says.

Axel Lehmann, chief risk officer at Zurich Financial Services, says local perspectives are continuing to gain in importance. He points to the success of nationalists in Finland's recent elections, saying: "The True Finns' gain is likely to have a significant impact over the future of the European sovereign debt discussion."

Richard Ward, chief executive of Lloyd's of London, the insurance market, adds it has become apparent global trade is susceptible to what used to be thought of as local events. He points to the recent earthquake and tsunami in Japan, and the Icelandic volcano's ash cloud last year.

"What people are waking up to is the interconnectedness of global trade – a single missing chip from Japan can shut down a Ford factory on the other side of the world," he says.

"The ash cloud had an extraordinary impact on UK airspace – suddenly you were hearing about Kenyan bean farmers and flower suppliers going out of business because they couldn't get products to market in the UK." He adds that while he cannot see globalisation slowing down, there will have to be a broader diversity of supply chains.

Mr Lehmann echoes the importance of regional diversification. "Some companies had significant information technology services outsourcing in Egypt, which has been severely disrupted [by the recent political collapse]," he says. "This shows you need geographic spread in business."

John McClosky, global head of risk consulting at Marsh, the broker, says that as businesses have become more global they have not always been fully aware of the extra risks.

"Companies tend to think about things threat-to-threat," he says, "but now people are demanding a threat-neutral approach – focusing on ensuring that they can deliver their services or goods in any circumstance."

A more wide-ranging approach is



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Single track: the Angolan government is expressing concern about the extent of Chinese investment in the country

Getty Images

needed, Mr McClosky says. "It is about making your business more resilient, having suppliers in different parts of the world, having interchangeability of parts, for example the same components being used in different cars, and generally building in more flexibility."

"Managements should be thinking like this rather than relying on saying 'this event was unprecedented', which investors and boards are less likely to accept as an excuse."

Axel Theis, head of Allianz's global corporate insurance business, says insurance can supply some, but not complete, certainty about business continuity costs through contingent business interruption insurance and similar cover.

But an insurer needs to know all about the supply chain and who the suppliers are. "We have certain limits for named suppliers and less for unnamed suppliers," Mr Theis says. "The amount of information companies will give has improved in the past couple of months, but incidents like those in Japan give further impetus for this. People are now giving much more financial and earnings impact data – they previously said this was commercially sensitive."

Michael Denison, research director at Control Risks, the consultancy, says as companies strive for resilience, they will look to new countries.

"If companies see an opportunity where they can go in with their eyes open, then definitely they will do so, especially if it's about energy," he says. "Places such as Turkmenistan, Angola and Algeria, are all very difficult but getting a lot of interest."

Kroll's Mr Glapion says sub-Saharan Africa is receiving a lot of attention, partly because some countries can offer stable regimes and growing middle classes, but also because some Chinese companies that had enjoyed a relatively free rein are experiencing problems because of their treatment of labour. "There is a backlash and this gives western companies an opportunity to exploit by offering to do things better," he says.

For evidence of a backlash, JLT's Mr Robson points to strikes in Zambia over labour conditions and the Angolan government's growing dis-

comfort at having Chinese companies as its sole investing partner, but he is less convinced there is an opportunity for western companies.

"The Chinese will change practices if they see economic reasons for doing so," he says. "In five to 10 years, once the infrastructure projects start to fade and deteriorate and the Chinese are still taking the resources, then maybe there will be a real backlash."

But even as globalisation marches on, there are concerns that some countries will be left behind. Mr Deni-

son says Libya is a good example because the arguments are all about who can or will commit military assets. "The demand for peacekeeping is not going to fall, but the supply is not increasing," he says.

"If a country is marginal, or not important in terms of trade or oil, then it is likely to be left to its own devices. There was a feeling in the 1990s that we must never have another Rwanda. But it actually looks as if, more than ever, there is nothing to prevent one."

'Places such as Turkmenistan, Angola and Algeria are all very difficult but getting a lot of interest'

Gap between old and new economies closes

Emerging markets

The pattern of potential problems is changing, says **Masa Serdarevic**

As developing markets grow and mature, the risks that come with investing in these economies is evolving. Often in unexpected ways.

Such markets were once the preserve of a small group of brave investors, but an increasing amount of capital held by pension funds and asset managers is being allocated to them.

And with those fastest growing economies becoming ever more complex and sophisticated, they are tak-

ing on some features of more developed markets – and, in turn, some of the risks associated with those markets.

Hazards such as the appropriation of assets and politically motivated currency devaluations, which a decade or two ago kept risk managers awake at night, have become less common, investors say.

But more complex risks are emerging. As governments, regulators and businesses attempt to manage the rapid growth, policy upsets are a growing concern for investors.

"Risks are becoming more sophisticated," says Plamen Monovski, chief investment officer at Renaissance Asset Managers, a specialist emerging and frontier markets investment group with

\$2.2bn of assets under management.

"It's part of the normal evolution of a market as it matures," he says. "The risks are becoming more and more like those in more developed markets."

Regulatory risk, for example, is a growing problem in Russia and eastern Europe, according to Mr Monovski. "In many of these countries there is no regulatory experience," he says. "It's often a case of trial and error and many of the rules are evolving constantly."

That leaves fund managers vulnerable to newly introduced sets of regulations undermining a previously attractive local investment.

Health and safety as well as mobile communications regulations are particularly



Monovski: golden rule

prone to change in Russia and China, for example.

But while governments of developing countries grope for effective regulatory frameworks and risk models, potential role models have been heavily discredited by the financial crisis of recent years.

Risks commonly associated with the developing world, such as nationalisation of private companies, windfall taxes and sovereign default, shook the world's most developed

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Do global markets feel

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Growing confidence dented by politicians

M&A

Anousha Sakoui assesses the lessons in recent high-profile interventions

The economic recovery, even though still fragile in places, has helped spur hopes among advisers of a recovery in mergers & acquisitions. But this year has brought a new set of uncertainties that risk upsetting company boards' growing confidence.

Dealmaking has increased this year but it has not been without its difficulties. A string of multi-billion-dollar cross-border deals since the credit crisis began has been besieged by regulatory and political interference.

"There is more political interest in certain countries in looking at whether takeovers are in the national interest," says Simon Marchant a senior corporate partner at law firm Freshfields. "There are particular sectors that are more sensitive to interference such as energy and resources, where security of supply and related issues really do have national importance. This clearly adds to the deal risk that companies face."

Last autumn saw one of the most high-profile deal failures, when Australian miner BHP Billiton was forced to abandon a three-month pursuit of Saskatchewan's PotashCorp after failing to secure the Canadian government's approval for its hostile \$39bn bid. This was despite undertakings made by the miner to the Canadian authorities that it described as

"unparalleled in substance, scope and duration". According to the Canadians the deal failed to meet a test that it should be of "net benefit" to Canada. The bid had been widely expected to win approval until Brad Wall, Saskatchewan's premier, launched a campaign against it that quickly snowballed. Mr Wall urged the government to "stand up for Canada" and its national strategic interests by rejecting the bid.

A similar issue has come up in the London Stock Exchange's proposed merger with Canada's TMX Group – operator of the Toronto and Montreal exchanges. The politicians are again concerned about a shift of the group's balance of power abroad.

But it is not just Canada that has proved a difficult jurisdiction for dealmaking. In April, the Singapore Exchange's \$8.4bn (US\$8.8bn) bid for its Australian rival was blocked by the Australian government, which said the takeover could undermine Australia's position as a financial centre, as well as jeopardise the stability of the country's financial system.

Earlier this year Italy's government started talks over the adoption of rules to thwart unwanted foreign takeovers in sectors deemed strategically important, such as energy, telecoms, technology, defence and food. The move came amid a backlash against French buy-outs of Italian companies after jeweller Bulgari, energy group Edison and food group Parmalat were wholly or partially taken over by French companies.

"To manage political risk, buyers often need to convince governments in the target's



Deal-breaker: Brad Wall, Saskatchewan premier, speaks out against BHP Billiton's pursuit of PotashCorp

home jurisdiction that the acquisition will be good for the country," says Piers Prichard Jones, corporate partner at Freshfields.

"Buyers also need to assess the risk of a change in the political or tax regimes in the country after the deal has been done. Bilateral investment treaties between the jurisdictions of the target and buyer – if in force – can offer some protection but in some cases you can never close off political risk entirely. And in those cases, buyers need to have a carefully thought-through exit plan before they do the deal."

Some bankers say the phenomenon is a feature of the recent recession, and will lessen once economic conditions are more positive. However objections to US company Kraft's controversial \$11.5bn (\$18.8bn) hostile takeover of Cadbury, the

UK-headquartered confectioner, has led to a recent review of rules governing takeovers in the UK that would reduce bidders' potential tactical advantages. Some argue those proposed rule changes could now impede deals in a country that has been seen as one of the most open to takeover activity.

The question for acquisitive corporates is how to avoid such pitfalls, which can prove costly. Mark Aedy, head of Europe, Middle East and Africa at Moeils, the investment bank, says increased protectionism means acquirers need to do more pre-acquisition planning. But, he adds, "with careful, discreet planning anticipating all possible issues from multiple constituencies, deals can get over the line."

Other risks are growing in importance, though. Simon Tin-

kler, head of Clifford Chance's corporate practice in London, says: "There is a greater flow-back of potential liability with mergers and acquisitions than previously. One example is the new bribery act in the UK. In an M&A context, people are more rigorous on what could flow back from international purchases and that makes deals more complicated, time-consuming and expensive."

Mr Marchant advises clients to be consistent with their messages to regulators in all their markets. "You can't just suddenly change the line. You need to be taking a long view and be doing the groundwork well in advance of an acquisition actually happening. Companies today need to have a more sophisticated approach when dealing with antitrust regulators than was once possible."

Other risks are growing in importance, though. Simon Tin-

Gap between economies closes

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economies and some continue to do so.

Despite that, however, potential investors are still likely to put more time and resources into due diligence for investments in emerging markets than in the developed world.

Sven Richter, head of frontier markets at Renaissance Asset Managers, says that accounting standards in many African countries, for example, "are not as bad as you would think". But a shortage of auditors makes it difficult to take the figures at face value.

Investors often need specialist help to see such problems.

"Clients come to us for what is not in the public record. In many of these countries the public record is inadequate. They want a deeper assessment of a market," says Melvin Glapion, managing director of business intelligence for the UK at Kroll, the risk consultancy.

"We talk to government ministers, regulatory bodies, companies, competitors to get a better understanding," he says.

Mr Glapion cites the example of stringent new emissions standards being introduced in China, where some models from local car producers do not meet the new criteria. He says that following conversations with government ministers it became clear that the new rules are unlikely to be enforced in full.

In a similar way, investors may be comforted by a country's laws that safeguard property rights, for example – only to find on further digging that these are not always enforced.

Looking behind nominees to find who else has an interest in

'Russia's public relations is poor, and out of date. Corporate governance has improved a lot'

Look for the single point of failure

Supply chains

Earthquakes and unrest have put pressure on suppliers, says **Andrea Felsted**

From the rising cost of raw materials to extensive disruption caused by the earthquake in Japan, companies face a range of risks in what is becoming an increasingly complex web of supply.

The Japanese earthquake has underlined the difficulties companies face in ensuring that goods are delivered from various parts of the world reliably and on time.

According to Gary Lynch, global leader of the supply chain risk management practice at Marsh, the insurance broker, the disruption from the earthquake has highlighted "the need to look further upstream, beyond first-tier suppliers". This takes in "all level of suppliers and contractors. That includes the supply chain, as well as the need to look at the infrastructure, the ports themselves, and transportation."

Qadir Marikar, a partner at consultancy PwC, says suppliers have been becoming increasingly specialised, for example making just one component, which can lead to a "critical point of failure".

He also stresses that it is important to look beyond the first layer, to ensure that all the companies are not all in turn sourcing components from a single supplier.

"Go backwards," he says. "Where is the single point? It's not just about looking at your suppliers, but at your suppliers' suppliers." David Noble, chief executive of the Chartered Institute of Purchasing and Supply, says: "When I started out, it was all about 'just in time'. Now it's 'just in case'."

He points to the example of Japan supplying 90 per cent of the world's specialist resins



Spillover: floods in Pakistan pushed up cotton prices AFP/Getty Images

used in the semiconductor industry, which meant a widespread impact from the recent earthquake and tsunami.

"This is major impact stuff. It is fundamentally going to change how the supply chain and supply chain risk are viewed," he says.

He says there will be a greater role for third party aggregators, which hold inventories for companies, but at a cost.

Kristian Park, director of contract risk and compliance at Deloitte, says it is not only the Japanese earthquake that has raised awareness of the issues in the supply chain, but also the violence in the Middle East and north Africa.

Throughout the economic downturn, he says, most compa-

'This is major impact stuff. It is fundamentally going to change how the supply chain and supply chain risk are viewed'

nies concentrated on the financial resilience of their suppliers. They have now been forced to consider threats such as natural disasters and political instability.

Such events have also underlined the need to have a plan to cope when something does go wrong so that goods and services can still be delivered to customers.

Mr Lynch says most business continuity plans concentrate on the asset itself. "But as we have learnt from all these catastrophic outages over the last couple of years, everything from violence to oil spills, you really can't control the threat scenario, nor can you control the ramifications," he says.

Business continuity plans must therefore also look beyond

first-tier suppliers and further into the web of supply.

In Japan's automotive industry, for example, many dies and moulds have been lost – and contractors do not have duplicates.

Catastrophic events can also have ramifications through the supply chain. For example, floods in Pakistan last year helped push up the price of cotton – a key component for the clothing industry.

Some companies are moving to source from new regions to reduce costs and ensure supply, for example, moving from the industrial hubs of coastal and southern China to the north or west. Others are leaving China altogether, moving to areas such as Bangladesh, southern India and Sri Lanka.

As companies source further afield, their supply chains lengthen – and new suppliers also bring new risks.

Mr Lynch says some companies are recognising this and factoring it into their calculations when they decide where to base production.

"The smart organisations, and some larger ones, are calculating that cost as part of their [risk management] and they are realising the cost to comply is just as great."

Other companies are choosing to control the cost escalations in the supply chain by sourcing nearer to home.

Retail billionaire Sir Philip Green recently told an industry conference he was considering investing in UK manufacturing.

But Lord Wolfson, chief executive of fashion retailer Next, says the costs of sourcing closer to home still outweigh those of manufacturing in south-east Asia. "Wages in the UK are five to six times what they are in the most expensive Far East markets," he says.

"Bear in mind labour is 50 per cent of the cost of a garment. It is not viable."

Theory and practice are both failing us

Guest Column
JEROME BOOTH

Risk has many meanings and is difficult to assess, but the way we think of risk often fails to pick up the structural shifts that include some of the biggest risks of all.

When we do not know the probability distribution of random events, we call it uncertainty. When we do, we call it risk which we can hedge or insure. But one person's risk may be another's uncertainty, because of differences in information and liabilities. We can also turn some uncertainties into risk, but they are not the same.

We often ignore uncertainty because it cannot be measured. Indeed this is a problem for economics and not just for finance.

Robert Skidelsky's interpretation has uncertainty as a major plank of John Maynard Keynes's *General Theory*. When faced with high levels of uncertainty, an entrepreneur will invest nothing. If there is enough uncertainty in an economy this may lead to suboptimal private investment, justifying government stimulus instead to boost (Keynes's new term) aggregate demand. This is incompatible with the use of rational expectations theory as a foundation for macroeconomics, and indeed much of finance theory.

Risk is also not volatility. Someone standing, blindfolded, on a railway track may experience no volatility at all until suddenly they face rather a lot. If their peers are also standing, blindfolded on the track, they may gain some comfort from being in a crowd, but it will not make a lot of difference to the actual risk.

As an example of the difference between risk and volatility we can think of currency movement. If a central bank has substantial reserves, it has the ability to protect its currency – as many emerging central banks do today. But if, after the collapse of a bank such as Lehman Brothers, central banks are worried about another major

financial crash, they may want to keep their firepower in reserve and allow their currency to weaken against, say, the dollar.

An analyst may view this as volatility in the country's currency as opposed to volatility in the dollar. If, more than two years on and having had time to think about it, another western financial crisis occurs, triggered by sovereign default in a Eurozone country, a central bank could protect its currency from any weakness simply by selling reserves – and probably will.

Asian central banks did intervene to prevent currency weakness when the price of oil rose in the wake of events in Libya, and after the Japanese earthquake.

The problem with finding patterns in past data and extrapolating is that it precludes the possibility of picking up structural shifts. The biggest macroeconomic risks we face today are so infrequent that we simply do not have enough data to extrapolate from. Not since the 1930s have we faced as much deleveraging in western Europe and the US as we do over the next decade.

Macroeconomic imbalances, structure and behaviour are key to understanding risk and hence today's asset allocation, not just past volatility – especially as we are now in a world where we might reasonably expect more structural shifts.

Another example of how our standard tool set fails to cope with structural shifts and the biggest risks concerns liquidity. Liquidity in an asset or asset class can change

suddenly, reducing to nothing, in ways never experienced before. To understand this we need to understand the structure, views and likely behaviour of the investor base in different future scenarios. Just understanding what liquidity has been may be insufficient.

Risk is also perceived as binary: places with risk and places which are safe. We even describe investments as "risk-free", which is an absurdity – there is no such thing as a risk-free investment.

I define my area of investment, emerging markets, not by risk but risk perception – all countries are risky, but emerging markets are those where the risk is priced in (although we may argue about whether it is priced correctly).

A developed country is one where domestic investors do not even think about their own sovereign risk. The developed world is where governments are given a licence by bond markets to be fiscally irresponsible.

The first role of an active manager in emerging debt is to reduce risk, and the riskiest way to invest is, arguably, passively.

Sovereign risk often builds gradually and is fairly visible as a source of potential risk long before

catastrophe strikes. Therefore avoiding major risks is often relatively easy – except if you just buy the index.

Jerome Booth is head of research at Ashmore Investment Management



a company is also crucial – especially as they may fall out of favour with the government.

While Russia is arguably most associated with that risk, some investors caution against relying on old prejudices.

"Russia's public relations is poor, and out of date," says one fund manager. "Corporate governance has improved a lot."

Mr Monovski agrees, citing reform efforts currently being pushed through by Dmitry Medvedev, Russia's president, including the order for government ministers to step down from their positions on state companies' boards by July 1.

"The Kremlin knows that if they don't strengthen and diversify the economy, it won't be able to sustain another shock to the price of oil," he says. That cannot happen unless investors are better protected by the law, and that law is enforced.

For now, however, investing in developing markets is likely to remain more turbulent – as the troubled deal between energy giants BP and Rosneft, with the involvement of the Russian government, illustrates. The golden rule of investing is too important to ignore, says Mr Monovski. "If you don't fully understand the risks, don't get involved."

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Research is a key tool in sub-Saharan goldrush

Africa

Cover against common hazards is available, says Sharlene Goff

The pro-democracy protests that have swept through northern Africa in recent months have shown only too clearly how fragile the political framework is across much of the region.

But the turmoil in Libya, Egypt and Tunisia has done little to curb the enthusiasm of foreign investors to tap opportunities across the more southerly sub-Saharan region, which is emerging as a hotspot for growth in telecoms, natural resources and financial services.

International companies from Europe, the US, Asia and, now Latin America have been avidly looking to increase their profile in key African nations such as Kenya, Rwanda, Uganda and Zambia in the aftermath of the financial crisis.

British banks Barclays, HSBC and Standard Chartered, among others, have made African growth a priority as they seek to capitalise on the continent's increasing prominence in global trade flows and catch its rapid infrastructure development. Meanwhile telecoms companies are hoping to benefit from the explosion of mobile phone and internet use.

Analysts say the sub-Saharan countries tend to be more stable – and welcoming to foreign investment – than those in north Africa, although clearly there are still pockets of extreme volatility such as the Democratic Republic of Congo and Sierra Leone.



Heeding the call: a rapid rise in the use of mobile phones in Nigeria and other countries is too attractive for global telecoms companies to want to miss out on

AFP/Getty Images

Individual markets within Africa have their own complex dynamics and risk factors, experts warn, and the political and economic risks in even the most solidly democratic markets must be managed effectively.

"Political stability is the key risk that businesses need to get to grips with," says Jason Mosley, a senior Africa analyst at Oxford Analytica, the global analysis and advisory firm. "The events in north Africa have made that clear – and it is firmly on the radar of companies looking to invest in the region."

The concern is that agreements made with one government could easily be reneged on – or scrapped – by a new administration.

Some African nations also have under-developed economic, legal and judicial infrastructures, experts warn. Bernard de Haldevang, head of financial and political risk at Aspen Insurance, says: "Most do not have adequate insolvency legislation, while legal and political systems are largely lacking in accountability or transparency. Not to mention outright corruption. All these factors create

issues for any company wanting to make long-term investments that are likely to endure beyond one administration."

The Multilateral Investment Guarantee Agency (MIGA), a division of the World Bank, provides political risk insurance – or guarantees – against losses arising from five key risks when investing in emerging markets such as Africa.

These are: expropriation or nationalisation of assets by governments; damage to assets or business capability from war, terrorism, and civil disturbances; problems transferring

currency out of the country or converting it into foreign exchange; government breach or repudiation of contracts agreed with the investor; and a government's failure to honour sovereign financial obligations.

Large insurance companies are also increasingly providing political risk and credit insurance.

Mr de Haldevang says insurers are investing heavily in their political intelligence research capabilities to enable them to make better underwriting decisions and to help clients manage their own risks.

But, while the market is improving, insurers are inevitably still cautious about backing projects in volatile regions.

Evan Freely, global leader of political risk and trade credit at Marsh, the insurance broker, says it is easier to secure cover for projects of one or two years, rather than longer-term projects such as mining developments.

He says local governments are less likely to interfere if the projects generate foreign exchange – oil exports, for example – and brings international enterprise and business experience to the country.

Mr Freely says the market for providing risk cover to foreign companies in Africa is mature so it will not vanish if volatility increases. And, he adds, "Firms tend to see a decent amount of recovery [of claims] now by working with governments."

While risk insurance can help mitigate losses, analysts say that companies' best form of protection is ensuring that they have a deep knowledge of a country before they invest.

Mr Mosley warns, though, that information provided by some nations may not always be reliable and transparent.

"Investors need to understand the political context – how long a horizon the government may have, how prone it is to changing regulation and on how firm a footing the government's finances are," he says.

"Could it suddenly change the tax regime, for example?"

Some companies hope to mitigate the risks by bringing in advisers who are well connected politically. They can help to ensure that the authorities are onside from the start, says one. "The key is knowing who to ask for help, and having good networks on the ground."

"Political stability is the key risk that businesses need to get to grips with"

Food and water supplies show strain

Climate change

Companies ignore weather-related issues at their peril, says Paul J Davies

As European governments debate the costs and benefits of better or different flood defences, some of their counterparts in north Africa and elsewhere have been besieged or toppled at least in part as a result of the soaring cost of food.

The two are linked by the role that the climate, and particularly the threat of a changing climate, has played. Some of the key questions for governments and companies include how climate change could affect them and what they can do to prepare for it.

This goes further than being just about the impact of too much rain at the wrong time, or not enough when it is needed.

Elizabeth Stephens, a political and security risks expert at Jardine Lloyd Thomson, the insurance broker, says commodity and especially food prices will continue to be a huge problem in the coming years. They fed directly into the recent unrest in Tunisia and elsewhere, for example, but they are far from the only climate-related risk.

"The other thing about to hit is water shortages," she says. "Yemen is about to run out of water."

Jonathan Woods of Control Risks, the risk consultancy, says water is going to be increasingly important. China, India and the US south-west are among the areas under pressure, he says. "The price of water is going to fall on companies and they should be managing the risks around how they prepare for that."

Some companies have already run into water-related difficulties. Coca-Cola, for example, faced protests and was eventually asked to shut down a bottling plant in the Indian state of Rajasthan after its use of water took a heavy toll on a region already hit by drought.

Mr Woods says this kind of problem shows how companies need to focus on maintaining a "social licence to operate". That involves engaging with local communities and political leaders.

"Climate change is not necessarily the source of risk in many areas, but it can be an amplifier," he



High-value commodity: Yemen faces a water crisis

AP

says. "One of the biggest risks for companies now is related to protest and direct action from climate change groups or local communities."

However, there is a much greater level of concern and involvement over climate-related issues among communities in the developed world than in emerging markets. "This is because people in developed markets are further removed from the immediate economic benefits of a particu-

"The biggest concern from an insurance perspective is about more tourist ships – because they are single-hull"

lar plant or activity," he says.

There are also new risks that are accompanying climate change.

James Wallace of RSA, the UK insurer, says his company is working on a programme with the World Wildlife Fund to monitor hazards and changes in the Arctic, especially around the north-west passage, where warmer, longer summers means less ice and so more shipping activity. There is also going to be significantly more oil and gas exploration in the region, he says.

"There are big risks – it's more difficult to salvage and rescue up there

because there is no infrastructure, very few ports," he says. "But the increased activity means more environmental risks for the animals and habitats there."

"We are starting to see more Arctic shipping activity, but the biggest concern from an insurance perspective is about more tourist ships going up there because they are single-hull and if they get struck by something, they're in a whole lot of trouble."

The biggest question, though, remains the extent to which climate change is the driver of hurricanes, cyclones and flooding that have hit the world with apparently increased ferocity and regularity in recent years.

It is still proving extremely difficult for scientists to extract a clear sign of the effects of climate change from the normal long-term historic cycles of weather and climate activity. That is despite simple logic saying that a warmer climate should result in more powerful storms because of a greater water content in the atmosphere.

Axel Lehmann, chief risk officer at Zurich Financial Services, says it is necessary to take a long-term perspective – of 200 or even 1,000 years.

"In terms of severity and frequency, is this type of event happening in a more systematic way? We do not yet have an answer on that," he says.

"But on a systematic basis we do know that a growing population puts pressure on the earth and its resources."

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Legal minefields sit on national borders



Sign of the times: the Lehman collapse left a legacy of litigation about who has priority over assets in a large number of jurisdictions

The law

The level of harmonisation between countries is still relatively low, writes Jane Croft

At the same time as international business is becoming more global and interconnected, legal systems remain essentially national.

International companies must navigate judicial systems ranging from the common law varieties typical of English-speaking countries to the Romano-Germanic types used in countries such as Switzerland and Turkey. For multinationals, the risks of falling foul of local laws can include big fines by regulators and reputational damage, as well as lawsuits that could have been avoided.

To complicate matters, in recent years the complexity of international finance and the law has accelerated, particularly in some areas such as insolvency.

This was illustrated by the collapse of US investment bank Lehman Brothers in 2008 as the financial crisis hit – which split the bank into hundreds of separate entities.

Lawyers say the complex task of unwinding Lehman will lead to years of litigation and numerous court battles in different jurisdictions about who has priority over what assets.

But there are ways that multinationals can prevent – or at least man-

age – these cross-border legal risks. In extreme cases, they can simply choose not to do business in countries seen as high risk.

They may alternatively opt for joint ventures with a local business partner so they can tap into specialised knowledge to ensure compliance with local laws.

Many US and UK law firms are opening offices in fast-growing markets such as Asia and Latin America to provide their corporate clients with the necessary depth of local knowledge.

Lord Tim Clement-Jones, London office managing partner and international business relations partner at law firm DLA Piper, says many companies use global law firms that have a local presence in key markets.

“The essence is to provide clients headquartered in one country with legal and regulatory advice of a comparable quality in local markets to what they receive from us in their home country, taking into account the local legal regime, the competitive context and enforcement risk,” he says.

Companies can deal with risk more easily if they avoid adopting a one-size-fits-all approach. “Where this is not possible or practicable – for example with an online presence across several different jurisdictions – then a highest-common-factor approach may be necessary. But there needs to be a balance between likelihood of enforcement and the costs of compliance,” Lord Clement-Jones says.

Companies may use a strategy of evaluating the legal risks and assess-

ing the probability and severity of loss. Some companies also seek to transfer risk to other parties by, for example, limitation of liability clauses in business contracts.

But companies often fail to look carefully enough at whether they have the correct insurance cover.

Nigel Pearson, UK and Ireland underwriting manager at Chubb Insurance, says: “A lot of the clients we insure are multinationals and are looking for simple insurance solutions. However it is not always easy to provide certainty in territories that require policies to be issued by locally admitted insurers.”

“We have had claims from companies operating in certain jurisdictions where the authorities have sued them because they have not had the correct licences, for example. It can be surprising how often some of the basic groundwork has not been done.”

“It’s not unusual to come across companies which have great risk management models on paper and comply with corporate governance codes in principle – but in reality the appropriate behaviour is not necessarily embedded in the day-to-day activities of the businesses.”

As business becomes more global, there have been moves in more international sectors such as banking to standardise contracts relating to certain types of deals such as over-the-counter derivatives transactions. The International Swaps and Derivatives Association (ISDA) has set up master agreements that spell out each party’s obligations, for example.

There has also been an increasing

tendency by big companies to opt for business contracts specifying that any legal disputes will be dealt with using international arbitration rather than local courts.

Such arbitration can be helpful, especially if multinationals do not trust the independence or speed of the courts in some countries where they operate.

But risks remain in some areas such as anti-corruption enforcement. Industries such as energy and infrastructure have become favourite targets of US prosecutors, creating a host of legal, commercial and reputational problems for companies.

‘It is not always easy to provide certainty in territories that require policies to be issued by locally admitted insurers’

Lord Clement-Jones says the riskiest areas are “probably extraterritorial application and enforcement of anti-corruption/bribery rules from different jurisdictions which may differ significantly”.

Once, payments to government officials in some countries were regarded by many as a cost of doing business.

But changes in the legal landscape over the past decade have left companies and executives more vulnerable to sanctions under anti-corruption laws. The late 1990s signing of the anti-bribery convention of the Organi-

sation for Economic Co-operation and Development led to anti-corruption legislation being toughened in many countries.

Companies can now more easily face fines and executives face jail for corrupt activities anywhere in the world.

Last year, for example, defence contractor BAE Systems agreed a \$400m fine with US prosecutors to end corruption investigations in the US and UK without admitting bribery.

In 2008 Siemens drew a line under its bribery scandal when it agreed to pay €1bn in fines to the US and German authorities.

For companies, one of the biggest threats is exclusion from public works if they are convicted of corruption, under rules set down by the EU, World Bank and others.

The UK’s new bribery act – which comes into force in July – finally brings UK rules on corrupt payments into line with other OECD countries.

The UK government had to publish guidance to help companies interpret the act, as some companies were concerned that areas such as corporate hospitality could be outlawed under the new act.

But many investors still remain unhappy that it will be left up to the UK courts to decide whether a company operating overseas with a London listing will be covered by the act and can be prosecuted.

Initiatives to stamp out graft in Asian countries are also under way. They include 28 Asia-Pacific governments signing up to a regional anti-corruption programme overseen by

the OECD and the Asian Development Bank.

But Trace, the US non-profit association that tracks cross-border corruption, lists 10 Asian countries including China among the world’s top 34 nations for bribery.

Compliance lawyers say that the Department of Justice and the Securities and Exchange Commission in the US have become increasingly aggressive at enforcing the Foreign Corrupt Practices Act, with the number of investigations up from five in 2004 to 56 in 2010.

Recently French telecoms group Alcatel-Lucent agreed to pay \$137m to US authorities to resolve allegations that illegal payments were made to government officials in Malaysia, Thailand and elsewhere.

But, while companies operating across borders do face increased complexity in the regulations governing their behaviour, they also can reduce their legal risks.

“There are one or two things companies can do to address issues,” says Mr Pearson of Chubb.

“They include looking at whether their insurers have the ability to issue local policies in certain territories, whether they have a global network of offices to administer their insurance and, from a risk perspective, whether or not their risk management register encompasses all the areas that need to be looked at.”

“The companies should also assess whether they have a reasonable strategy to address such risks, be it insurance or some other form of risk mitigation.”



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Theft should not be part of deal

Fraud and piracy

A complete awareness of the hazards is crucial, says Paul J Davies

Counterfeiting remains rife in many emerging markets. Fashion brands, mobile phones and drugs are targeted mercilessly, especially in Asia. Fraud also continues to be a massive and intractable problem. Yet companies are still eager to tap into the fast-growing markets where both risks are prominent.

In China, 98 per cent of companies have experienced at least one fraud, according to a report compiled by Kroll and the Economist Intelligence Unit.

Violet Ho, an expert on fraud for Kroll in China, says that the true figure is actually higher because most fraud goes undetected.

To add insult to injury, the underdeveloped legal system means it is nigh on impossible to punish fraudsters if they are caught, without pursuing a difficult and costly civil action. “Usually you have to ask them to resign and pay them off,” she says.

The problem is not going away. Fraudsters are growing more sophisticated and the frauds are growing much larger, with more parties involved and more collusion. “There is a lot more cross-border fraud and multiple layers of corporate veil involved – it is not unusual for BVI [British Virgin Islands] companies to be involved,” Ms Ho says.



Bags of trouble: a ‘buy originals, not fakes’ sign on seized counterfeits in France

Frauds are usually perpetrated by ordinary people, motivated by money, acting corruptly rather than by organised criminal syndicates, she says.

“Most fraud, one way or another, starts in-house,” she adds. “Senior managers may set up shell companies for use in embezzlement. Even external fraud involving suppliers usually starts with an insider.”

However, John Hurrell of Airmic, the risk managers’ association, says that companies’ continuing desire to invest in countries such as China does not mean they are willing to accept fraud as a cost of doing business there.

“We absolutely have to have a supply chain that

includes Russia and China,” he says. “This doesn’t mean to say that people are prepared to take on much more risk. But they are prepared to go much further with their eyes open to assess the risks.”

In China especially, there is now more investigation of partners, and early contact with local regulators and police – so that the first contact is not when there is a problem. “There are also more western managers getting involved on the ground,” Mr Hurrell says.

On piracy of goods and ideas, pulling out of a market will not necessarily provide any protection from counterfeiters. Luke Foord-Kelcey, a telecoms and technology expert at JLT Insur-

ance Brokers, says: “If someone is going to copy you, they will whether you’re there or not,” he says.

One of the biggest risks for technology companies, he adds, is not having their products counterfeited but unwittingly breaching someone else’s intellectual property rights.

Launching a product in the highly litigious US can be very risky and he points to the recent €1.7bn settlement between Nokia and Qualcomm as an example. “You can innocently infringe IP. Just because someone’s registered a patent, doesn’t mean you’re going to find it.”

A further big issue, says Nick Robson, an interna-

tional political risk expert at JLT, is the sanctity of contracts, especially after political changes.

Contractual problems are well known in countries such as Russia, Venezuela and the central Asian states, he says.

But increasingly they are seen in African countries where democratic governments have re-examined contracts signed by previous dictators.

There is an international arbitration court at the World Bank, but some countries say the nature of the contracts and the arbitration are seen as neocolonial or undermining a country’s sovereign status.

“The World Bank has sympathy with countries and their ability to act as a sovereign,” Mr Robson says. “It would be quite rare to see a US contract subject to international arbitration, but that’s partly because the law itself is seen as sovereign and reliable.”

But whatever the problem, the only solution is for companies to know as much as possible about their partners and their political status and connections, experts say. Proper protection comes from thorough investigation beforehand – rather than trying to manage problems after the event.

In China, Ms Ho of Kroll says that those who do find themselves the victim of fraud should not overreact. “It happens to good companies and good people,” she says.

“You just have to try and investigate it fully to understand what happened – and learn from the experience.”