# Board Perspectives: Risk Oversight

## Managing Country Risk

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Country risk[1] comprises the various risks of investing in a foreign country that can lead to either investment impairments or reductions in returns on investment (ROI). Investment impairments may arise from confiscatory actions by a sovereign (e.g., nationalization of the business or expropriation of assets). ROI reductions may arise from discriminatory actions by a sovereign directed to the company, a targeted industry (say, energy or banking) or companies from certain countries (e.g., additional taxation, price or production controls, exchange controls, currency manipulation, expansion controls, performance requirements and other regulations). Both may arise from destructive or disruptive acts by others (e.g., violence, terrorism, war, strikes, infrastructure deficiencies, kidnappings or physical phenomena). The primary objective of managing country risk is to protect company investments in foreign markets and sustain acceptable investment returns.

### Key Considerations

Recent events beginning with the Arab Spring in 2010 have demonstrated that once governments undertake confiscatory or discriminatory actions, mobs take to the streets or civil war breaks out, crisis management and damage control options available to a company are limited. Because events in high-risk countries can occur with little warning, companies should analyze regularly the portfolio of countries in which they operate. An effective country risk assessment requires an evaluation of such factors as political stability, financial stability, economic outlook and exposure to corruption. Unfortunately, this assessment often lacks precision and is rarely integrated into a proactive decision-making process. Some companies use research firms that provide indices that give an indication of relative risk but are lacking in terms of suggesting exactly what decision-makers should do. One reason is that extreme high-impact, low-likelihood events are simply unpredictable.

Following are some points for multinational companies to consider when faced with high-risk situations:

**Empower local management –** When risky situations arise, make sure local management is on top of it and empower them to do what they have to do to take any and all necessary steps to protect the safety of employees and safeguard company assets. On-the-ground management understands better than anyone what's happening, and they're privy to the cultural nuances that can make or break the successful management of risks surrounding an organization's personnel, operations and assets. Because companies are morally obligated to do what they can to protect the health and safety of local employees and expatriates in a foreign country, make it clear to local management that employee safety trumps all other aspects of the business.

[1] Sometimes referred to as "sovereign risk" or "political risk."

**Reduce exposure to confiscation or discrimination –** When the company is exposed to confiscation that can lead to significant investment impairments or to some form of taxation, price controls, exchange controls or other discrimination directed to the company that can reduce ROI significantly, the following are actions to consider to reduce the exposure:

- **Repatriate cash:** If exchange controls and currency conditions allow, repatriate as much cash as possible – after considering the requirements for sustaining local operations – to reduce the risk of losses due to confiscation. Simply put, if there's any concern about whether a sovereign could target your company's money, then best to get the cash home as quickly as possible.
- **Manage down investments:** Treat the operation as though it's a "cash cow" until conditions stabilize and management can better gauge the company's ongoing interests in the country. Avoid any additional capital investments while, as noted above, repatriating whatever cash you can. Stop replenishing inventory from abroad and look for ways to finance payroll, maintenance and other operational functions through local cash flow.
- **Divest/disperse/exit:** Initiating an exit strategy by divesting assets in the cool of the day is always an option, if there is a willing buyer. Obviously, it is not likely to be viable when violence and anarchy break out. Moving tangible and non-tangible (e.g., data files, intellectual property) assets out of harm's way may be a good strategy to consider, if feasible. For example, if the company has a fleet of vehicles or heavy equipment close to known "hot spots," it may be best to move them to other locations away from the fighting and violence. Though it's often an option to distribute valuable physical assets elsewhere, beyond where the heavy action is expected to be, it also can create exposure to violence and looting if the present regime pulls in its police and military forces to protect its interests.
- **Share the risk:** While not a guarantee, entering into joint ventures with local/foreign partners is a way to reduce exposure to confiscation risk since the presence of nationals can take a multinational under the radar. If cost-effective, political risk insurance is another option covering the risks of confiscation, political violence, insurrection, civil unrest and discrimination, among other things.

Other options may also be available, such as passive options like lobbying and maintaining good relationships with local unions.

**Consider the trends when assessing risk –** Assess the risk of similar exposure in other countries in which you do business by understanding the driving forces of change and take proactive steps to manage that exposure. Given the power of social media to help quickly mobilize demonstrations, there is the risk that what's happened in Egypt, Libya, Syria, Tunisia and Yemen could embolden similar activity in other countries around the region and possibly other areas in the world. Pay attention to countries with a disaffected middle class with high unemployment and an inability to participate in the political process. Watch countries exposed to runaway food price inflation, such as those with a low GDP per capita and a very high percentage of food consumption relative to total household consumption. Watch closely countries besieged with pervasive entrenched corruption or those facing a potential water supply crisis, food shortage crisis and/or unsustainable population growth. The complexities and interconnections that underpin many of these global risks can move the masses.

**Conduct a post-mortem –** When an adverse event arises in a particular country, review the assumptions your company previously had concerning that country from an economic, political and financial system risk standpoint. If a consultant was used, what were the results of his or her research, and what advice emerged from that research? Did management see the event coming? If not, why not? If management saw it coming, did the organization take steps to prepare? Could the company have done anything differently? A post-mortem provides management an opportunity to review what happened and determine "lessons learned" they can apply to other countries in which they operate.

The world is a dynamic place with many forces at work at once. Multinationals can expect continued challenges from political instability in the future.

## Questions for Boards

Boards of directors may want to consider the following questions in the context of the nature of the entity's risks inherent in its operations:

- When evaluating whether to invest in a new country or region, are risks specific to the country or region carefully considered in the decision-making process? Is the board involved in a timely manner to assess the risks and rewards of making such investments? Does the board have access to expertise in investments in foreign operations to ensure the right questions are asked?
- When evaluating prospective or current foreign investments, are people with hands-on experience and current contacts on the ground in the country or region in question providing input to the assessment process? Does the company have access to international and local legal counsel who either are currently involved or were recently involved with projects in the country or region?

## How Protiviti Can Help

We assist companies with assessing their risks and capabilities for managing those risks. We help organizations identify and prioritize the risks that can impair their reputation and brand image. Our intent is twofold: Help companies (1) increase the robustness of their business strategy through better anticipation and management of risk in executing the strategy, and (2) integrate risk and risk management with the core management activities that matter.

## About Protiviti

Protiviti **(www.protiviti.com)** is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit. Through our network of more than 70 offices in over 20 countries, we have served more than 35 percent of FORTUNE 1000® and FORTUNE Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

Protiviti is partnering with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on www.directorship.com/author/jim-deloach/ in the "Blogs & Opinion" section. A compilation of blog posts and articles is maintained and categorized by author's name. Twice per year, the previous six issues of *Board Perspectives: Risk Oversight* will be consolidated into a printed booklet that will be co-branded with NACD. Protiviti will also post these articles at Protiviti.com.

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