Risk Management in Emerging Markets
Risk Management in Emerging Markets
How to survive and prosper
CARL OLSSON
To Stewart for inspiration.
To Hilary for patience.
“Companies increasingly have to do business with emerging markets to keep their competitive advantage, but the risks involved are quantitatively and qualitatively different from these in more developed economies and have important cultural dimensions. In *Risk Management in Emerging Markets* Carl very clearly helps the reader understand the nature of the unique risk encountered in emerging markets and discusses a variety of methods for managing such risks in a clear and accessible way. The book captures significant practical experience in a field and markets that risk managers can no longer afford to ignore.”

**Michael (Mike) Frow, Chief Executive Office, Harris Trust Bank**

“Carl’s lively, comprehensive and refreshingly readable book is built on his extensive practical experience in emerging markets banking. It is characterized by easily understood explanations of the technical concepts, as well as real–life insights and examples, from the Titanic to Thailand, that will often prompt a wry nod of recognition. This is essential reading for positive–minded risk managers in changing markets, whether emerging or developed.”

**Mick Green, General Manager, Retail Risk, ANZ Banking Group**

“Much needed, practical and very readable. This excellent book will be welcomed by those with business in emerging markets and especially by banks operating in these risk challenging environments.”

**Tony Jennings, Senior Advisor, Bank Training Centre, World Bank Group, Mekong Region**

“There can scarcely have been two more salient concerns for senior managers in multi-national companies over recent years than the management of risk and the exploitation of emerging markets. It is something of an achievement, therefore, for Carl Olsson to have brought these two key issues together under one heading. Olsson’s text not only provides a comprehensive introduction to the subject of risk management in all its many and varied guises but also shows how the principles of risk management can, and indeed should be, extended to exploiting opportunities in emerging markets. Many case studies enliven this text and make it an indispensible guide for managers and students of management, seeking to explore this very topical subject.”

**Ian Turner, Director of Graduate Business Studies, Henley Management College**

“This book offers a refreshing approach to the appreciation of risk management. Olsson is to be congratulated for his practical and novel approach to the subject – an essential read for all students.”

**Professor Joseph Nellis, Head of Economics Group, Cranfield School of Management**
It is said that everyone has at least one book in them but in reality most never get past the idea stage. In my case, I must thank ex-boss Mike Frow for handing me the task of putting together an internal training course which meant I was required to think about risk and risk management, determine what the key messages were and consider the best way to get them across to an audience of recently joined graduates. Over the past four years I have delivered many such courses and have updated the content regularly as risk issues have come to the fore and techniques for managing risk have changed. Preparation for and feedback from these sessions helped me develop a number of the ideas which have formed the core of the risk management section of this book.

For actually suggesting the idea of writing the book and moving it beyond just an idea I owe a significant debt to Stewart McNaughton who conceived the project and then helped me through the initial stages. Since then he has provided constructive criticism as the book has passed through many iterations.

Along the way I have had input from a number of colleagues at Standard Chartered Bank, past and present, as well as others who have helped me to understand risk and risk management better and/or have provided useful feedback on various drafts of the text. Those worthy of special mention are Geoff Burgess, Mani Ilangovan, Daniel Mwagi and Ting Zhang. There are countless other friends, colleagues and customers that I have worked with around the globe over more than 20 years that are too many to name but should be recognized. They have provided me with a wealth of experience, “war stories” and case studies that I have been able to draw on to highlight some of the issues that arise when seeking to do business in emerging markets.
I must also thank Laurie Donaldson from Pearson Education who was receptive to the idea of the book and has guided and encouraged its progress as it has unfolded chapter by chapter.

A final thank you has to go to my wife Hilary who lost sight of me for many an evening and much of the weekends for several months during the preparatory and then drafting and redrafting stages. A thank you goes to sons Ian and Neil who also did not see as much of their father as they probably should have during this period.

Needless to say I take full responsibility for the ideas and concepts explored within the book. Comments and feedbacks would be most welcome. I can be contacted via e-mail at carl.olsson@virgin.net.

Carl Olsson
Carl Olsson studied Economics at Cambridge University before joining Standard Chartered Bank, a UK based banking group with operations in more than 50 countries largely in Asia, the Middle East, Africa and Latin America.

After initial training in the UK Carl was relocated overseas and lived and worked in various emerging market countries, including India, Hong Kong, Bahrain, Turkey, Thailand and Brunei, over a period of nearly 20 years. He is currently London based where he works in Group Risk Management function of the bank where he is involved in a variety of risk related projects which have a global reach. In the last few years he has become more involved in developing and delivering risk training to internal and external audiences.

During his time overseas Carl held a variety of positions in both front and back office which included senior management positions in business and risk units. A substantial period of time was spent working with multinational companies who were either running or seeking to establish operations or undertake contracts in emerging markets. In addition, he had considerable exposure to business issues in these countries from dealing with large local corporates and small businesses as well as non-profit organizations such as the Royal Brunei Yacht Club where he was Honorary Treasurer.

In addition to a degree in Economics he has obtained ordinary and degree level banking qualifications and an MBA from Henley Management College.
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Imagine that you are called in by your boss and told you have been chosen to set up a new call centre. You feel good as it’s a new job and a new challenge. Then he tells you the call centre will be in India. That’s definitely a challenge, so do you feel excited or concerned? If concerned, is it because of what you know or what you don’t know? You know call centres but not India, then again, life is all about seizing opportunities. To obtain rewards from opportunities it is necessary to take risks. What we intend to explore is very much this scenario – the combination of risk and emerging markets.

A basic premise that we will explore is that operating in emerging markets is riskier than doing so in the developed world. This is largely because they are often characterized by greater economic and political instability and are more vulnerable when external shocks, such as natural disasters, occur. This is, however, no reason to steer clear of these markets because there are higher levels of return on offer for those that understand and can manage risk effectively.

Think about setting up that call centre. Why would your company want to do it? A prime reason will be lower costs. A major cost in such operations is labour so, with technology having shrunk the cost of calls between New York and New Delhi to a fraction of what it was ten years ago, it now makes sense to set up operations at a considerable distance from customers … provided the associated risks can be managed. What sort of risks they are and how they can be mitigated is a question we will seek to enable you to answer.
Many of the risks that exist in the developed world also exist in emerging markets but there are other new twists that mean they appear in different guises. In addition, there are a number of new risks that you will have to face and deal with, some will undoubtedly be unexpected. A prime reason for these differences is the cultural differences that exist between developed and emerging markets. Different backgrounds, different religions, different values and different languages all bring a diversity which impact on how people see situations and how they deal with them. People that live in cultures based on deference and respect for elders, for instance, sometimes have difficulty dealing with risk when they see things being done by senior management that they think is wrong as speaking up would be seen as disrespectful. At a more basic level, simple translation errors can cause enormous problems unintentionally.

If this was not enough, the nature of risk itself is changing because the world has become more complex and interconnected. On top of that, the pace of change has accelerated and people have become less tolerant of risk. All this means that events that happen in one country have an impact in unexpected places and in unexpected ways. Russia defaults and threatens the US financial system. An earthquake in Japan brings down one of Britain’s oldest investment banks. A downturn in the US threatens textile suppliers in Malaysia. The stories go on.

This accelerated pace of change affects countries in the developed world as well as emerging markets. Developed countries, however, have greater depth and resilience and are not so easily impacted by sudden and unexpected events. Emerging markets can be like spinning tops – one nudge and they go off in an uncontrolled direction. Developed countries are more like oil tankers – it takes a lot to push them off course and a long time to take effect. Part of the reason for this vulnerability is poor economic management which is often linked to political factors such as strong or charismatic leaders remaining in power for decades and looking after their own interests. The spread of democracy appears to be no protection against this.

The purpose of this book is to help those who are faced with situations described in the opening paragraph, those who have business connections with emerging markets, or students with an interest in risk management and how it must be viewed differently in the more volatile climate of emerging markets where risks are different and solutions that work in the developed world are not always available.
In order to meet this task the book is in three sections. Part One deals with the basics of risk and risk management. Chapter 1 covers what risk is and explains why it is important to think of risk in a positive light – the corollary of risk is opportunity, but we mostly think of risk avoidance rather than risk exploitation. A key objective of this chapter is to convince you that there are many ways to look at risk and that we all do it differently. Understanding other people’s point of view is a definite asset when discussing risk and how to deal with it.

Part One then deals in sequence with the key elements of risk identification, measurement of risk and risk management. It may sound obvious that the failure to identify risks up front will make it difficult to manage them effectively, but risks are often taken on by line managers whose first thought is revenue not risk. In emerging markets this can be lethal. It is increasingly important because of the changing nature of risk. Hacking, for example, did not exist before computer systems were connected to telephones. Reputational risk was less of a threat before green activism started in the seventies and the activists’ actions started hitting the headlines.

Identification of risk is only the starting point, however. Being able to measure risk is important as a basis for decision making. How big the risk is and what the impact would be if it occurred are important dimensions to understand when thinking of risk strategies. Unfortunately, not all risks are easy to measure and in emerging markets data is often not available and is rarely of good quality.

The need to overcome these first two hurdles means that by the time we start thinking about risk management in emerging markets we are already at a disadvantage. Managing risk in all environments is a critical success factor for the future but in emerging markets the skills needed are different. It is not about blindly following the rules, often set in Head Office thousands of miles away, because the environment is changing too fast for the rules to keep up and people in Head Office could not write a sensible set of rules that would apply in all countries in all situations. What is needed are managers who are risk aware and able to use judgement and common sense. People that understand the environment and who have been entrusted with sufficient authority to act when necessary without calling the folks back home. By risk aware managers we mean people in line functions, salesmen, production management, technology support and so on, not people in the risk management department. This is important as everyone is a risk manager, though many would not say so if you asked them. Everyone in business performs some sort of risk management function day in day out but they often do it subconsciously.
The risk management process starts with setting the right strategy and involving risk professionals in the debate, as partners not adversaries. It carries through to the development of a risk framework appropriate to the company’s strategy. That risk framework must be adequately resourced so it can operate effectively with a degree of flexibility which will allow it to respond to an ever-changing environment. Today the problem is that risk is like a bar of soap. No sooner do you think that you have it under control than it shoots off in an unexpected direction and you have to scramble around to get it back in your grasp. This requires flexibility and good people – not a rigid command and control approach that parent companies have tended to adopt when managing their emerging market subsidiaries.

Having looked at some basic building blocks in Part One, Part Two looks specifically at emerging markets and explores what works and does not work well in that environment. Chapter 5 looks specifically at the nature of emerging markets. This is an interesting area to explore, as there is a dearth of literature on it. Though there are many books with emerging markets featured tantalisingly in their title, they are virtually all about investing in stock markets. Very few even consider defining what constitutes an emerging market though they all have long lists of countries that they classify as such without explaining why. Our stance is somewhat different. We are more concerned with the risks facing long term investors who put their money in real not financial assets. Companies that are committed to the long term and do not flee at the first currency crisis or political upheaval. More specifically we seek to answer the question of what makes emerging markets different and how this impacts on risk, not how it is possible to make a quick return. The key points here are that familiar risks appear in new guises or behave quite differently while completely new and unexpected risks can assail the unwary newcomer more or less anytime. In particular, it is these new and unexpected risks which are often the downfall of new ventures in these markets – security risks, corruption and religious and tribal conflicts being just some of them.

Chapter 6 looks at a particularly important distinguishing area for emerging markets – culture and language. Anyone working or dealing with emerging markets must understand and respect the culture of the country they are operating in. Not only that, they must be acutely aware of their own culture and how it differs from that of the countries they are dealing with. In addition, they must be aware of language traps. Communication is only effective if the recipient understands exactly what you wanted them to understand. This can be difficult, even where both parties speak the same language, if the coding and decoding process breaks down. Where one party is not a native speaker of the other language being used this problem is compounded.
Chapter 7 brings together issues on risk and risk management from Part One with the characteristics of emerging markets explored in Chapters 5 and 6. The basic premise here is that risks are different and the environment more volatile which means that risk management techniques which work well in developed markets do not help as well or, in some cases, at all in emerging markets. Alternate approaches need to be adopted. Corruption and fraud, for example, are common problems that must be overcome. In addition to dealing with risk, companies must think about uncertainty. Unexpected events are more likely to occur in emerging markets and ones that are expected can be more severe while volatility is higher, even with simple problems like utility failures, or more pervasive ones like the overthrow of the government. Companies that have thought ahead and planned well will do better than those that have not.

Part Three looks forward. Risk management is becoming a core activity and is verging on the mainstream across a wider range of industries than was previously the case. Risk is now a profession, Chief Risk Officers are more commonly seen in Fortune 500 companies and more and more board directors are taking on responsibilities for risk. This is all necessary because of the changing nature of risk (remember the bar of soap). It is evitable that risks will continue to evolve and we will, in ten years’ time, be managing risks we have not thought about today using techniques and theories not yet invented. We cannot predict the future so the survivors will be those that hope for the best but plan for the worst rather than work on the basis that what they have forecast will come to pass.

The approach of this book is to raise issues and use real examples to illustrate points. Throughout we will draw on three scenarios to help provide a more practical theme linked to emerging market issues. These three scenarios are:

- the establishment of a call centre;
- a company project managing a construction contract;
- a business setting up a manufacturing operation to supply the domestic market.

These scenarios will be used to illustrate generic issues that arise when operating in emerging markets, not those that arise in particular countries.

Throughout this book we will be looking at issues from the perspective of a business that has its home base in a developed economy and one or more operations in emerging markets. While of particular interest to managers in
or about to work in emerging markets, and managers in the home base who
deal with the overseas operations, the content will also be of interest to stu-
dents of risk and risk management as well as people working in non-profit
or development organizations. The style aims to balance theory and practice
but the theory will not be overly technical or mathematical in nature. There
is no particular industry bias though examples of more sophisticated risk
management techniques are necessarily drawn from the finance industry.

A key theme throughout is that risk manage-
ment is about controlled decision making not risk
avoidance. Balancing risk and reward is increasingly
important but reward does not come without risk.
Consider the following.

**Think ships**

Ships remain fairly safe when they stay in harbour but they were not built
to spend all their time there. They earn money for their owners by cross-
ing the oceans carrying cargo or passengers. This requires them to take
risks. Before setting sail, potential risks need to be assessed and decisions
made. Weather forecasts are checked and the ship checked for sea
worthiness. If things are within tolerance levels, the decision to go is
made – risk is accepted. The ship will stay in harbour if bad weather is
close or there are problems with the vessel – the risk is avoided. The
process does not stop there. Continuous monitoring occurs, someone
watches the radar, and decisions can be changed if circumstances war-
rant – risk is monitored and decisions revisited if circumstances change.

We could continue to develop this analogy but you see the point. All busi-
nesses tread this fine line between risk and reward. The difference is that
risk in emerging markets is like sailing on a tempestuous sea without all
the safety equipment you would like. It can be an exhilarating and reward-
ing ride or it can lead to disaster. Being better at understanding and
managing risk in such situations will improve the probability that the
former rather than the latter occurs. Helping you to understand how this
can be done is what we aim to achieve with this book.
**References**

Throughout the book specific references are quoted for each chapter. The following are general references of value to those interested in risk and emerging markets.

For a general introduction to risk and risk theory in an easily readable format:


For an eloquent discourse of a non-scientific approach to decision making:


For a useful update on current tool, techniques and issues relating to risk and risk management:


For a very readable account of the ups and downs of emerging markets:


For theory and practice with respect to cultural and cross border management issues:


For a discussion of the current risk issues and concerns:


**Useful websites**

- **www.erisks.com** – risk related site with up to date news on trends and issues in risk management.

- **www.iif.com** – publishes country and regional reports on various emerging market countries.

- **www.economist.com** – contains articles and archive material from *The Economist* including country surveys.
PART ONE
Risk and risk management
CHAPTER 1
What is risk?

“Risk is a remarkably subtle notion.”
RON S. DEMBO
ANDREW FREEMAN

The history of risk

Risk is a word that has changed its meaning over the years. In feudal times, people’s lives were quite narrowly defined in terms of their location, role and knowledge. They were fatalistic and believed in religion and magic. There was little room for the term risk, as lives were considered pre-ordained meaning that individuals had little or no ability to influence what would happen in the future. They were resigned to living with the consequences of events that they could not control.

Over the centuries this changed as the level of commercial activity increased and people ventured further afield. Voyages of discovery opened new horizons and developments in the fields of science and mathematics meant that the fatalistic view of the world became less dominant. People started to understand that risk was associated with human actions and that this meant they could exert some control over it.

It took some centuries and a number of key milestones to expand people’s understanding of risk and to develop the key components of the toolkits used daily by today’s risk managers. Amongst the most important of these milestones were the developments of:
• the laws of probability (Pascal/Thermat)
• utility theory (Bernoulli)
• an understanding of regression to the mean (Galton)
• diversification theory (Markowitz)
• strategy/game theory (von Neumann).

All of these are well covered in Bernstein’s book *Against the Gods – the Incredible Story of Risk* (1997).

One of the first ways in which this change in understanding manifested itself was the development of the insurance industry. Initially this covered marine risks once merchants realized they could pool their risks and obtain recompense in the event of loss. This was a much more satisfactory situation than simply allowing their vessels to set sail while praying for a fair wind and no catastrophes. The key to doing this was having a sufficient number of parties paying in to the central pool and a means to determine what an appropriate level of payment (insurance premium) would be required to ensure that the insurance pool could pay out.

**Risk business origins**

In 1687, Edward Lloyd opened a coffee shop in London. It became a place to exchange information on shipping which became formalized with the establishment of the Lloyd’s List in 1696.

In due course, Lloyd’s of London developed to become the world’s centre for marine insurance. Over time it became the leading player in the whole insurance industry through building larger pools of risk and expanding coverage to all areas of risk. As a result, the term risk management was, for a long time, virtually synonymous with the insurance industry.

**Risk today**

Today the term risk has become commonplace and appears in many different guises as the following recent headlines indicate:

“Council topple tombstones over safety risk”

“American bank faces risk of failure”

“Homes at risk of repeated flooding will lose insurance cover”
“Report shows drivers aged 18–24 and over 70 are higher risk”

“Beware products promising a very high level of income. Invariably they carry a level of risk to your capital that is not immediately apparent”

“Risk of US recession increased”

These quotes indicate that the term is used in a wide variety of contexts which impact both our personal and business lives. They also raise a number of questions about risk, including the following:

- what does the term risk actually mean?
- how well do people understand the term?
- do we actually think about risk when taking actions?
- do we deal with risk consciously or unconsciously?
- do all people have the same perception of risk?
- are the risk decisions we make rational?
- is there a difference in how we consider risk in our personal lives from our business ones?

These and other questions will be addressed in this and other chapters, starting with the most basic of all questions which is, what does the term risk mean?

**Definition of risk**

Most people asked to define the term will suggest something along the lines “risk is the possibility of adverse consequences happening”.

It is quite common to think of risk from a negative aspect and define it by reference to adverse consequences only. This is, however, too narrow a viewpoint to take because it focusses attention on potential losses and draws it away from the possibility that there can be benefits obtained from taking risks. As businesses are essentially based on the premise that they need to take risks in order to earn a return, it is important to avoid this narrow viewpoint, particularly in the context of this book which seeks to help readers manage risk in emerging markets to improve levels of return.

Bearing in mind this viewpoint the definition that we will adopt is:

risk is the uncertainty of future outcome(s).
This is a short and simple statement that suggests that risk is something that happens in the future but cannot be predicted exactly today because there is uncertainty. Risk and uncertainty do not have to be negative factors and this is a key thought that we need to retain throughout this book. Let us consider in more detail what we mean by uncertainty.

Uncertainty in this context has two dimensions:

1. **The range of possible outcomes**

   The range of possible outcomes resulting from an event or an action can be narrow, limited or unknown.

   There are a few situations where the range of possibilities is very narrow. Think of tossing a coin. Most people would limit the possible range of options to two – heads or tails. In practice, if you toss a coin in the air and let it fall on the ground there are other possibilities, the coin could end up on an edge or it could roll away and become lost. Heads or tails remains the most likely outcome but this simple example does highlight the fact that one of the key requirements needed when looking at risk is keeping an open mind so you do not limit yourself to looking only at the obvious. A common term for this is avoid thinking in boxes.

   A wider, but still limited, range of possibilities occurs when a dice is thrown. In a long distance running event, such as a marathon, the number of possible winners may be large but it is known that it can only be one of the people officially entered into the event. For the major city marathons the number of possible winners can run into thousands but the number is still a finite one.

   With some risks, possible outcomes can be hard to foresee. The Millennium Bug was a good example of this as the range of possible outcomes was more or less infinite. Environmental impacts are another good example of this.

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**Dormant risks bite hard**

In October 2000, Owens Corning sought to protect itself from creditors after losing a legal battle caused by class actions suits (it went into Chapter 11 in technical terminology).

Those suits were effected by individuals who had become ill or had died as a result of working with asbestos more than 30 years earlier when risks were not well known and adequate protection was not provided to workers.
example. Events that took place many years ago are now having considerable reputational and financial impacts as the failure to see the long term impacts of activities was not envisaged at the time.

In today’s world, the range of possible outcomes is forever increasing so the importance of having an open mind is rising. This is particularly acute in emerging markets. We shall return to this in depth later but in the meantime let us consider the other dimension of uncertainty – probability.

2 The probability of an outcome occurring

Probability means the chance that a particular outcome will occur. In some cases this is relatively easy to determine such as when a dice is thrown e.g. the odds of a particular number coming up are 1 in 6, assuming the dice is not loaded. Another way to express this is to say there is a probability of 0.1675 or 16.75 per cent of the predicted number turning up.

In many other cases it may not be possible to calculate a probability exactly, in which case it will only be an estimate. Weather forecasters might, for example, indicate the probability of a particular type of weather occurring e.g. a 50 per cent chance of rain.

In other cases it may not be possible to calculate a probability at all. Natural events such as earthquakes and volcano eruptions are typically very difficult to predict with any certainty at all.

Unfortunately we are generally very poor at assigning probabilities to events. This is due not only to a lack of information but other factors such as bias and poor processing of available data. This is explained in more detail in the next section.

Before exploring this idea more, we need to consider the various possible combinations of outcomes and probabilities that can arise from the two aspects of uncertainty that we have described so far. These are represented in the uncertainty matrix set out in Table 1.1.

<table>
<thead>
<tr>
<th>Range of possible outcomes</th>
<th>Probability of an outcome occurring</th>
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<tr>
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The preferred position is, of course, to know all the possible outcomes and have well defined probabilities for each of those outcomes. Unfortunately the increased level of complexity in the world, and the faster pace of change, makes this preferred state ever harder to achieve. This is even more true in emerging markets. The importance of this is that where the range of possible outcomes and the probabilities attached thereto are unknown it is more difficult to manage risk effectively. This is not the only problem.

Risk is in the eye of the beholder

When looking at risk it is easy to fall into the trap of thinking of it as a definite thing. It is not like an apple, a car or a telephone. These are tangible everyday objects that everyone knows, recognizes and could draw for you if asked to do so. This is not the case with risk.

Risk is intangible and will be seen differently by different people not only in terms of what the risks are but also what the range of possible outcomes are and probabilities they attach to those outcomes. To put it another way, everyone’s perceptions will be different. The factors that will influence these perceptions include:

1  Experience

Inexperienced people do not usually see possible risks or, if they do, they underestimate the odds that they could be affected by them. A good example of this is the different viewpoints adopted by parents and children. Parents have experience and use this to try and prevent harm or injury coming to their offspring. Children often fail to appreciate this, or they may have a rebellious streak, and will often ignore their parents’ advice. Managers and subordinates have a similar relationship but in the workplace, managers generally have the power to ensure their views are followed which parents do not always have. In emerging markets, visitors are prone to overestimate security fears while local residents may underestimate them.

2  Knowledge

Not everyone has the same level of knowledge or information about a situation so it is not surprising that those with less knowledge may be more or less optimistic about possible outcomes. This difference in the level of knowledge can come about in many ways. It could simply be lack
of access, it could be because information is deliberately withheld or simply through not asking the right questions. Cultural issues can be important here if for example, people do not want to show ignorance or suggest they have not been trained effectively.

What has become apparent in recent years is that the level of knowledge in circulation has increased through greater publicity, newspaper exposés, the growth of the internet, active lobby groups, etc, which has meant that people’s understanding of risk has increased. A good example of this is environmental risk which people are now very aware of but this was not the case 20 or even ten years ago.

An increasing problem in this area is specialization. As the world has increased in complexity it has become more and more difficult for people to have in-depth knowledge of more than a few areas of business activity. As a result, people have specialized. Risk managers need to rely on inputs from such specialists more and more when making risk decisions. To add to the complexity, not all specialists agree with each other, making the manager’s job even more difficult.

3 Culture

Organizational, national and regional cultures can have a significant impact on how risk is viewed, particularly in centralized, controlled, family dominated or hierarchical situations where one view will often override all others.

**Changing circumstances**

In centrally controlled economies such as Russia, individualism was subsumed by the state. In the nineties, such economies have been opened to capitalist influences that exposed everyone to new risks such as price increases, unemployment, etc.

The culture which developed within these protected state run environments did not equip people to recognize or deal with all the risks in the new open economy.

This is of particular importance when dealing with emerging markets as we explore in depth in Chapter 6.
4 Position

In business situations, senior and junior management are likely to view risks differently because of their positions in the hierarchy. In part this will be due to experience and knowledge, but it will also be influenced by how each individual would be impacted by the particular risk. Such impacts may have tangible consequences – physical hurt or financial loss – or intangible ones – harm or enhancement of one’s reputation or self-esteem. The more significant the consequences, the greater the degree of risk some people are likely to see in a given situation.

5 Financial status

Putting a one dollar bet on a 100-1 outsider in a horse race with your last dollar would be seen as a more risky action than if you had a thousand dollars. An event that puts at risk a high proportion of an individual’s, or a company’s assets will be seen differently, therefore, than one that involves only a small proportion.

6 Ability to influence the outcome

Anyone who can influence the outcome of an event will view the risk associated with it differently. In some cases this might be fraudulent e.g. through having rigged the odds. In other cases, people’s views can be coloured through an illusion of control e.g. they think they have much more influence over potential outcomes than they actually do. They are overconfident, in other words.

7 Asymmetry

Equal weight is not given to loss and gain. Most people will put more weight on the impact of a loss than on the benefit from a gain. The greater the emphasis placed on the downside of a situation the more risk averse people are considered to be. This asymmetry comes to the fore in business when people are put in jobs where they are paid to take opposite views – sales and risk for instance. Swapping people between sales and risk roles can test how much this risk aversion is due to innate preferences rather than current position and incentives. Do risk averse risk managers remain risk averse or change their position when incentivized by doing deals?
8 **Complacency**
People may have not been affected by a risk event for such a long time that they become complacent. The probability of the risk event occurring may well not have changed over that time but their perception of that probability may well have done so.

9 **Inadequate time horizons**
It is easy to overlook risks by looking for too short a period behind or in front of you. The longer your past reference period is the more likely a risk event that you are considering will have occurred. People using different reference periods are likely to come up with different conclusions.

10 **Rose-tinted glasses**
We often, unconsciously, look back at past events and overemphasize the good parts and forget or downplay the bad parts. We are exhibiting selective memory. The consequence is that we may overlook what led us to make a particular decision and blame things that went wrong on bad luck rather than poor decision making. In such circumstances we are more likely to make the same (wrong) decision again.

11 **Single-mindedness**
We can be so focussed on one set of events and beliefs that we shut out all other possibilities, which is how fanatics act.

All of these influences will have an impact on how people perceive risk, what risks they think are most important, what they think the probability of a risk event occurring is, and what the impact of that event might be should it occur. Many of these issues are well covered in Helga Drummond’s book. The key drivers of people’s perceptions are beliefs and preferences:

**Beliefs** – the collective term for the factors that influence your estimate of the probability of an outcome occurring

**Preferences** – the factors which determine how much you prefer one outcome occurring over another

It is our beliefs and preferences that help us to make decisions. As these are both personal to us it is not surprising that there are often quite diverse opinions on risk and that this can lead to tension. A good example of this is the view of an applicant for a loan, who is always confident that he can
repay, and that of the loan manager who must take an objective view on the probability of repayment and make a decision. Whenever the answer is no, tension will result.

Cross cultural barriers to understanding and different bases on which beliefs and preferences are founded, means decision making is even more difficult when dealing with emerging markets, a subject addressed in Chapter 6. For a more detailed discussion of these issues Borge’s *The Book of Risk* is recommended.

We will return to the decision-making process shortly, but first a few more issues on risk itself.

**Risk is all around us**

Where does risk exist? The simple answer is everywhere. From waking up to going to sleep we are faced with risk at every turn:

- the water we clean our teeth with may be contaminated
- the milk we use for our cereal may be out of date
- the train we catch to work may be late or, at worst, crash
- our PC system may not work when switched on
- key staff may not turn up for work
- the big order that was going to save the company goes to a major competitor
- interest rates go up and raise our borrowing costs.

The list is more or less unlimited.

As we have said, it is important to have an open mind about risk in terms of what risks there might be, when they might impact and how they might impact on us. Forewarned is forearmed. Failure to do this has lead to adverse consequences for many a household name in the past – both individuals and corporates. Not only is it important to understand the risk you might face, but to react appropriately when something unexpected happens as history has taught us time and time again that we usually suffer as a result of the consequences of risk events we have not considered.
In January 1990 Perrier was adversely impacted when it went into denial over claims there were problems with some of its bottles of drinking water. Instead of accepting there might be a problem and recalling supplies, it denied the problem for a number of days.

It subsequently turned out that there was contamination in their bottling plant but by the time they admitted this it was too late. Customer confidence was undermined and Perrier took many years to recover the 40 per cent drop in sales that resulted. Coca-Cola had a similar experience in Belgium in 1999.

In Perrier’s case it eventually lost its independence when it was acquired by Nestlé.

This case illustrates that it is not simply anticipating risk that can create problems for companies but also the failure to take appropriate action once the risk has materialized.

Dimensions of risk

We have said risk is an intangible concept and will be viewed differently by different people, but we do need to try and rationalize it as far as possible. One way to do this is to consider the various questions we might want answers to before we make any decision on risk. These will include the following:

- how long will we be at risk for (time)?
- how big is the risk likely to be (size of exposure)?
- what is the probability of occurrence (probability)?
- how close to the expected outcome is the risk event likely to be (volatility)?
- is it a simple risk to understand (complexity)?
- how many types of risks are involved (inter-relationships)?
- can I manage this risk (influence)?
- what will it cost to address (cost effectiveness)?
- how will the risks change over time (life cycle)?
These are all important areas to explore in more detail, which we will do in Chapter 4.

**Risk and action**

*The high level process*

If we consider the last few sections and bring together some of the key points, it would seem that we have an impossible task given that:

- we may or may not be able to understand the range of outcomes
- we may or may not be able to assign probabilities to those outcomes
- we all view risk differently
- there are risks all around us
- we need to understand the various dimensions of risk.

If that were true, however, we would find great difficulty in dealing with daily life both in and outside the workplace. Somehow or other we are able to assimilate a wide range of information and take actions which allow us to safely navigate our way through each day or plan longer term activities with some degree of comfort both in our personal and business lives. Some examples are:

- deciding to overtake when driving. Those that err on the side of caution will not overtake and remain safe (rational, risk averse decision makers). Others will be more reckless and pay the price for poor judgement when they get it wrong (overconfident risk takers);
- managing a project. A project has a defined outcome. The way to achieve that outcome is to break the project down into bite sized pieces and manage the whole process through a project plan which details all the separate pieces and linkages and dependencies between them. Progress against the plan is then monitored on a regular basis to ensure the objective remains achievable or that action is taken if any adverse developments occur.
This is not to say that we never get things wrong. It is inevitable that this should happen on occasion and there will be some adverse impact. Also we are not always rational in making our decisions. Time is of particular interest here. For instance:

- **How often have you said “... but we have spent so much on this we cannot stop now”**. Approaching this rationally, whatever we have spent in the past is irrelevant. The only thing that counts is how much more it will cost to complete the task and whether the value from that is greater than the additional cost. Looking back in time prevents us taking a rational approach to the decision about future actions.

- **Deferring possible adverse consequences to the future, preferably a long way in the future, permits us to delude ourselves that we can heavily discount, or ignore, them. This will be particularly true where the consequences are not so immediate or obvious. Smoking cigarettes is one example. Cancer may develop many years later, or not at all, so millions of people continue to smoke even when they know they could suffer adverse consequences.**

What conclusions can we draw from these examples to help us think about risk in a more rational manner and deal with it more effectively? There are a number of things we can do but the process involved has a number of key steps.

1 **Understanding what risks we face**

We cannot consider managing risks effectively unless we have a clear idea what those risks are. There are hundreds of specific risks that we face day in day out but they will all fall into a limited number of generic risk areas. One such generic risk type is credit risk – the risk that someone we have given credit to will not repay us. Another we have mentioned earlier is environmental risk. You cannot understand risk if you do not know what to look for. Categorizing risks into generic risk categories helps with this process but only to a certain degree as it is easy to focus on one risk type to the exclusion of others (so-called silo mentality). Virtually all situations involve a number of potential risks and we must ensure that they are all identified, not simply the obvious ones. We will cover generic risk types in Chapter 2 together with other issues relating to the identification of risk such as the changing nature of risk over time.
2 Measuring those risks
Wherever possible, risks should be measured both in order to understand the probability of a risk event occurring and also to understand the size of the impact should it occur.

A simple example to consider is investing in publicly quoted corporate bonds. Many public companies are rated by rating agencies such as Standard & Poor’s and Moody’s and it is well known that buying a bond issue rated CCC, commonly known as a junk bond, is a much higher risk than one rated AAA or “triple A”. For the junk bond the probability is more than 0.1 or 1 in 10 that the issuer will fail to pay principle or interest when due, whereas it is 0.001 or 1 in 10,000 for the AAA rated bond. These risk ratings are indications of probabilities of default (a risk event) occurring. This is one dimension we want to measure the risk of. The other is the size of impact. For an investor this is measured by the size of the investment made in the bond. Investing USD 1 million would lead to a greater loss than investing USD 1,000 if default occurred.

For the above example, it is easy to put numbers on probability and impact but this is the exception rather than the norm. The ability to measure risk will depend on the type of risk involved. In some areas such as credit risk there is a high level of sophistication, but in others, such as environmental risk, it is much more judgemental. Apart from the type of risk, knowing the range of possible outcomes will impact on how precise we can be. In general, understanding probability is harder than knowing the impact though, as we have stated earlier, where the range of possible outcomes is unknown it will be difficult to assess both of these. Chapter 3 covers this area.

3 Deciding what to do (managing risk)
When we have identified the risks and determined some measure of these risks we need to decide what to do.

On the assumption that we have been able to identify the risks and make a reasonable assessment of the probability and size of the impact of a risk event, decisions are needed on what to do about the risk. Options are:

- take the risk as it is (accept it);
- take action to minimize either the probability of the risk event occurring or the impact should it happen (mitigate it);
- do not accept the risk (avoid it).
Making sure decisions remain valid (monitoring risk)

In cases where the risk is accepted or mitigated it will be necessary to:

- continually reappraise the risk to ensure it has not changed;
- make sure that an adequate reward is being earned;
- put in place contingency plans should an adverse event occur;
- ensure that there are adequate reserves to protect against losses arising from an adverse event (do not bet the company).

Figure 1.1, the risk loop, summarizes these four key elements graphically. We start with collecting information, process it to determine the risks and measure them, then we assess the risk and make our decision – accept, mitigate or decline. Once the decision is made we continue to monitor and go through the process again and again.

![Fig 1.1 The risk loop](image)

We will consider these ongoing risk issues in Chapter 4. Next we will look at the risk decision process in a little more detail.

Making risk decisions

When making decisions we must start with a clear view of where we are today. What we need to do is determine where we want to be, over various time horizons, and then consider the consequences of undertaking the various options open to us (accepting, declining or mitigating the risks).
In business, of course, decisions are not as easy to make as in games and knowing whether you made the right decision or not can take a long time to find out. The amount of information required to make decisions is also greater and there are many more unknowns. Beliefs and preference have a greater influence because objective hard data may not always be available and even if it is there is always room for interpretation. In addition, many business decisions have to be made quickly without full information to avoid losing the opportunity.

One way to help make decisions is to use a tool such as the probability/impact matrix set out in Fig 1.2. This is a simple 2 x 2 matrix that can be used to position various risks on a grid using the dimensions of probability on the vertical axis and impact on the horizontal axis. Even if there is

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**Playing games**

A useful analogy to make when thinking about how to make decisions is to think of it as planning the next move in a game. For most games you know where you are and the objective, to win the game, is well understood. However, you need to take risks to win.

What those risks are and what decisions you make about them will vary depending on the nature of the game, the environment in which you are operating, your belief in your own or your team’s capabilities, as well as those of your opponents, and so on.

At one extreme you have games such as chess which are played one on one. In chess you have a considerable degree of control over what you do and there are few external factors that can affect you. The outcome is largely dependent on the moves you make and your ability to counter any initiatives from your opponent.

In team sports such as football there are many more variables and external factors such as the weather and the referee can have a big impact on the outcome. Making a risky pass that is intercepted and leads to a goal can decide a game, yet playing conservatively may not help you win it.

Whatever the game, each player is continually looking at options and weighing up the consequences of making one choice or another. Once each decision is made, the consequences are usually quickly known and that information provides feedback which influences the next decision. Making right decisions leads to positive outcomes, wrong decisions to negative ones – you win or lose.
a lack of concrete information it will usually be possible to use some sort of ranking process which will at least help position things in roughly the right areas. Interestingly, asking a variety of people to position various risks on this grid can reveal a lot about beliefs and risk aversion. It is not uncommon, for instance, for risk managers and front line sales people to take quite diverse views on where an item should be positioned.

The matrix can be used to decide on whether to take on new risks as well as to reassess existing risks (risk monitoring). Here we should emphasize that there will always be more risks than can be managed so deciding which are not material and can be ignored is an important aspect of the decision-making process.

The use of such a tool allows us to consider what strategies we can use to manage risk. These are illustrated in Fig 1.3. When making decisions on new risks it is likely, for instance, that we would seek to avoid high impact/high probability situations unless these could be satisfactorily mitigated. For existing risks we would want to ensure that similar situations were already mitigated and that, if not, action was being taken to put in place mitigants or reduce our exposure. Therefore, making decisions on those events in the top right and bottom left quadrant are generally fairly easy.

For high probability events but low impact, the need is to put in place controls to minimize impacts. A good example of this is credit card fraud. This is inevitable in any credit card business so card companies are continually investing in technology and systems to minimize

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**Fig 1.2 Probability/impact matrix**

There will always be more risks than can be managed so deciding which are not material and can be ignored is an important aspect of the decision-making process.
the opportunities for fraudsters to defraud them. For high impact but low probability events, people hope that they will not occur but plan for the worst. Fire, flood, earthquakes or other natural disasters are good examples. These risks can be managed by preventive actions to minimize the impacts, earthquake proof buildings, taking out insurance and putting in place contingency plans. Insurance will cover the financial consequences of any impact while contingency plans will help cope with the physical impacts.

This tool, however, only helps us in a broad sense. Any situation probably involves a large number of risk decisions most of which will be made by individuals. Their beliefs will influence the level of priority they place on dealing with them but it is their preferences which will influence their actual decision. The theoretical underpinning for this is utility theory. The definition of utility is:

the amount of satisfaction derived from an object or activity.

The premise is that we can attach a value to utility that we can then plot in a utility curve. Figure 1.4 illustrates possible utility curves. The horizontal scale is denominated as a monetary measure, dollars, and the vertical axis in utility. The norm is the top curve which indicates that the level of utility declines the more money we have. The other curves, equal increases in utility or rising utility for the same amounts of monetary gain can occur but are less likely. This feels right intuitively because the more we have of something, whether it be money, chocolate bars, ice creams, holidays, etc, the less value we derive from each additional unit. This is known as the marginal theory of utility but a more common description for it is the law of diminishing returns.
The presumption of utility theory is that we will seek to maximize the level of utility that we have. In practice we do not go around consciously measuring things by utility but we will do it unconsciously as we weigh up the benefits from the various options open to us. This will apply equally whether we are in work or at home, though at work the things that we are trying to maximize utility from will be different e.g. we will derive utility from work relationships as well as from the things that we do at work.

This is not the place to go into utility theory in detail but it is useful to be aware of it when thinking about decision making. If you wish to know more a good read on the subject and in particular its impact on how we make risk decisions is Borge’s *The Book of Risk*.

Utility theory helps us to understand why we have asymmetrical views on risk e.g. why we might be risk averse. This is shown in Fig 1.5. If we assume that we have a normal utility curve, then we will gain less utility from an equal increase in the amount of money that we have the higher up the curve we are. Assume that we are currently at position A and we are faced with making a risk decision. If the outcome of the decision we make is favourable we will move from A to B, we have gained a monetary reward and increased utility. If the outcome is unfavourable, we will move to C, we have lost money and reduced our utility. The amount of money gained or lost is the same but the utility we attach to it is not. What this means is that we will be less keen to accept the risk because we attach a higher value to the potential loss than we do to the potential gain if our belief is that there is an equal probability of moving to B or C. We would be more likely to accept the risk therefore if we could increase the proba-
Fig 1.5 Asymmetrical views on risk

bility of a favourable outcome (improve the odds) or the level of the potential reward was increased (going up the curve requires more money to gain the same amount of utility as going down the curve). The risk management process is all about assessing risks in this way and seeking to improve the odds of a successful outcome. A successful outcome is defined as an opportunity gained as well as any downside impacts minimized.

When we do make decisions there are a number of factors to consider in addition to utility maximization. These include:

1 **Time**

   This has an influence in a number of ways. The types of risk that are relevant to a particular scenario will change over time. In some cases, these changes will follow a natural life cycle. The other important point to note is that the time available to make a decision may be limited. Many risk decisions have to be made quickly and with incomplete information. This will be particularly true in emerging markets where risks change quickly and time zones may prevent adequate consultation time before a decision is required. *Good managers of risk are able to make good decisions in a short time frame with incomplete information.*

2 **Risk management costs**

   All things have a cost. That includes taking preventive action to minimize risk. If however the cost of such an action is greater than the possible impact then there is little point in pursuing that course of action. We explore this some more in the section on risk and reward.
3 **Rational behaviour**

A point we have already mentioned is that much theory is based on the belief that people act in a rational manner. Reality shows us many examples where that is not the case. Statistics show that it is much safer flying than driving, yet some people will not fly but are happy driving. The odds of winning a lottery are millions to one but lots of people still take part. In business life, being irrational can lead to problems. Just think of the dot com boom – millions of dollars were raised in venture capital on the back of business plans with high expectations but little proof that they could generate cash. Even the companies considered successful such as Amazon have yet to turn in a single quarter’s profits.

4 **Extreme events**

Probability distributions indicate that events at the extreme, the very right or left hand ends of a normal distribution, have a low probability of occurring so does that mean that we do not have to worry about those “once in a lifetime events”? In terms of our probability/impact matrix they will appear in the far right hand bottom corner, high impact but very low probability. Such possibilities cannot be dismissed particularly as there seems to have been an increasing number of these extreme events occurring in recent years. In addition, and probably more importantly, low probability tells us nothing about timing. Even if the odds are “once in a hundred years” this does not mean that the event might not occur tomorrow.

5 **Authority**

We have been talking about decisions as if we were the decision makers but in a business context this may not be the case. Where this is so, it is not only our beliefs and preferences that are important but those of the other decision makers. This may be problematic particularly where their views diverge from ours. Where decisions are made by committee there is more scope for such a divergence of view.

6 **Conflict**

When we make decisions do we make them based on our own beliefs and preferences or in line with what we think we should do? Where there is a conflict between an individual’s beliefs and those of senior management, decisions may be made in line with what people are expected to do rather
than what they would prefer to do – is it better to make the right decision or tow the line? Retaining one’s job will usually mean doing the latter rather than the former. The impact on you influences decision making as well as your views on risk.

7 Creating new risks

We must be aware that any decisions we take will create new risks. What those risks are, and how they will impact on us and our business, need to be factored into the decision-making process. Think about car safety measures such as seat belts. The intention was to reduce the impact of a crash should one occur, but it is possible that a new risk has been created – over-confidence. If people drive faster or more dangerously because they feel well protected, risk may have increased rather than decreased. Managers running banks whose depositors are covered by deposit protection schemes may be encouraged to take higher risks than they would otherwise take – this is called moral hazard.

8 Simplification

In the real world, all risk decisions require some simplification. Over simplification can be dangerous.

All of the above need to be taken into account when thinking about decision making. It is clear that it is not straightforward. Helga Drummond, for instance, argues that it is more an art than a science as her book title clearly suggests. This distinction is important, the more so when dealing with emerging markets where information is less available and cultural factors come into play. We also need to consider how we differ in making decisions in our personal and business lives.

Business and personal decisions

Personal decision making is an activity distinct from our business decision making. The simple reason for this is that we, or someone close to us, usually bears the consequences of our personal decisions directly. If we do not insure our house and it burns down, the cost of replacing it falls on us. In business the consequences of making decisions are usually shared with others or completely passed on to them. If we make a loan and it is not repaid it is not deducted from our salary but offset against the company profits for instance. If production of an order is delayed the customer suffers. Business decisions usually lead to some sort of financial impact.
which will affect all the company’s stakeholders in one way or another. If the impact is small there will be little effect but decisions that go badly can affect the future viability of the business. Equally those that go well can lead to increased bonuses, new opportunities and better prospects but there is often no direct link to the quality of risk decisions taken.

How do the above considerations affect how we make decisions? In our personal lives we may be more cautious, but what about business decisions where the consequences are shared? If you were paying for a new investment in an emerging market from your own pocket, a new call centre in India for example, would you be more cautious? The answer is probably yes. What we need to do, therefore, is be aware of this distinction and ensure that we do not bring personal beliefs and preferences into play where these might influence our business decision capabilities.

For the rest of the book we shall put aside issues relating to personal decision making and concentrate on those that affect business risks and decisions.

**Risk and reward**

When considering risk it is important to remember that it is only one side of the equation. Risk must be balanced against reward. Indeed, Borge provides a good definition of risk management which is:

> the taking of deliberate actions to shift the odds in our favour. To increase the odds of good outcomes and to decrease the odds of bad outcomes.

This reiterates our earlier point about not simply focussing on the down-side aspects of risk. There are rewards for making right decisions. These come in many forms including:

- higher sales or profits
- increased share price
- increased market share
- industry awards and recognition
- high public esteem/customer satisfaction
- good reputation.
You already are a risk manager – we want to help you become a better one.

How important each of these are to an organization and its stakeholders, both individually and collectively, will obviously vary case by case. It is the job of senior management to determine the strategy for a business and set out its risk appetite. This will set the tone for how risk is managed within the business.

This is important because there is an argument that taking on more risk is acceptable as long as the reward is commensurate with that risk. This argument can be supported but only so far because there comes a point where you begin to bet the business on the future turning out as you expect it to. Betting a business on a large contract which will bring significant reward is fine as long as it works, but not if it fails and the business goes under. Concentration risk can increase exponentially and no level of reward can compensate for this.

Care is needed to ensure that there is an adequate balance between risk and reward in a business, but the problem as we have explained above is that people’s views on risk differ. It is not surprising that the sales managers, who are rewarded for generating sales, will have an optimistic view and that, risk specialists, who are paid to protect the business long term, will take another view. Senior management has the task of ensuring there is a fair balance given to both sides of the argument. This involves making decisions on risk. What we seek to do in this book is make you a better decision maker through raising your awareness of risk issues and particularly those associated with new and unexpected risks that characterize emerging markets. You already are a risk manager – we want to help you become a better one.

Why manage risk?

It should be obvious to everyone that it is necessary to manage risk in order to protect ourselves from the adverse consequences of a risk event occurring and ensuring that the benefits from taking risks are achieved. This is true, however, only if the risks are identified and recognized and conscious decisions taken to manage them – even if the decision is to do nothing.

It might sound strange, but doing nothing is actually a risk strategy. It is often one that is chosen but more often or not in ignorance. In practice, doing nothing may be the riskiest thing that we do. Quite often we get away with it but not always.
If we fail to manage risk we may suffer a significant impact which might be physical, financial or reputational. Even if there is only minimal impact we are likely to be distracted from our normal activities. The more this happens the more likely we are to spend time fire fighting rather than running our business.

To address this in the business world we need to ensure that we have in place a robust risk management framework. This will not only include processes for identifying, measuring and managing risks, but also provide mechanisms to enable feedback on changes in risks and crisis management procedures or contingency plans for those risk events which will inevitably occur from time to time which are not foreseen. We will address this in Chapter 4 and then consider what the characteristics of emerging markets are that make this a more difficult but potentially rewarding activity.

**Conclusion**

Risk is a topic of great interest to all business mergers as being able to manage risk effectively is increasingly a critical success factor. Risk management is not all about saying no, but helping people to say yes. It is about taking calculated risks. Unfortunately the world is becoming increasingly complex so the need to understand and manage risk effectively is increasing at a time when it is becoming more difficult to do so.

Furthermore, risk is not tangible nor universally understood. We will be better risk managers if we are more aware of the fact that everyone is going to see risks differently. We need to appreciate more fully why there are divergent views and take this into account when making decisions. Openly discussing risks will help everyone understand why a particular decision has been taken and will help develop a stronger risk culture. Bias and irrationality should be avoided. Decisions should be rational and practical, based on knowledge but tempered with sound judgement.

Remember, risk is like a bar of soap. No sooner do you think you have it in your grasp than it shoots off in an unexpected direction. This is particularly so in emerging markets. It is not going to get any easier in the 21st century.
Managing risk is all about seizing opportunities not simply avoiding risk.

Our understanding of risk has changed and developed over time. It is radically different from what it was in the past. We can expect it to keep changing.

Risk is the uncertainty of future outcomes.

Uncertainty can arise both in terms of what the future outcomes might be, as well as in putting values to the probability of their occurring.

Each of us is likely to have a different perception of risk, we need to keep an open mind.

Our beliefs and preferences drive risk decisions.

People are not always rational.

It is important to have a robust risk management structure not simply to manage risk effectively but to be well prepared when things happen which are totally unexpected, as will inevitably be the case.

There are too many risks for us to address. We must prioritize.

References


CHAPTER 2

Identification of risk

“Know your enemy, know yourself and your victory will not be threatened. Know the terrain, know the weather and your victory will be complete.”

SUN TZU

Introduction

Identifying the risk in a situation can sometimes be relatively easy, in others this is not the case. Occasionally, we become blind to the possibility that there is any risk at all. The latter point is well illustrated by the story of the Titanic.

The “unsinkable” Titanic

When the Titanic was built in the early 1900s it was claimed to be unsinkable. The reason for this, or so it was argued at the time, was the way in which the ship had been designed. The important design difference was that there were a series of bulkheads built along the keel of the ship that were intended to isolate any inflow of water in the event that the hull was breached. Because of this belief, the designers only included sufficient lifeboats to cater for half of the ship’s passengers and crew. As is well known, the ship was holed by an iceberg and sank on its maiden voyage. How could they have got it so wrong?
The main reason was the failure to consider all possible risk events. The Titanic was built to withstand the holing of one, two or three of its separate compartments but not several at once. Also though there were a number of compartments, they were not entirely watertight as there was an open space at the top of each bulkhead. When several of the compartments were holed they rapidly filled with water and eventually water flowed over the tops of the bulkheads into sections which were not holed. The ship sank within a short space of time before help could be provided by other ships.

Safety equipment to deal with the incursion of so much water was not available and there were insufficient lifeboats to take all the passengers and crew off the ship. The result of the lack of foresight and the failure to plan for the unthinkable meant that many more perished than should have.

We can draw a simple conclusion from this unfortunate experience – \textit{risks that are not identified are not likely to be managed.}

Therefore in terms of our three stage approach to risk management – identification, measurement and management – identification is the crucial first step. Without identifying risks effectively we will not get beyond the starting point. Consequently when unexpected events occur in the future it is likely that contingency plans will not be in place and management can only react to events as they unfold. Panic, poor decisions or complete paralysis may well result. Identification in advance means proactive rather than reactive risk management practices can be adopted.

So how should this vital task of identifying risk be approached? One way is simply to take a situation and list all the risks that we can think of. Let us try this with the first of the scenarios we set out in the Introduction. This envisaged the setting up of a new call centre in an emerging market; an in-house operation that will deal with customer enquiries from a number of countries across the globe for a major multinational business.

Regardless of location, the critical success factors for call centres are ensuring that there are sufficiently trained staff available to deal with the incoming calls effectively. To be effective they must be supported by communications and computer technology that is able to deliver the requisite information to the staff member as and when required.

When setting up a new call centre and then moving to operational status, some of the risks will be, in no particular order:
• lack of people with requisite skills (including language skills) to be trained for all required positions, including operators and technical support as well as supervisory positions;
• inability to receive incoming calls due to communication problems;
• lack of power caused by insufficient or unreliable utility providers leading to service disruptions;
• lack of adequate premises;
• staffing problems due to poor transport services, particularly late at night;
• dissatisfied staff due to lack of understanding of local cultural issues
• unable to complete premises on time due to inadequate information on local business practices – including how to deal with landlords, contractors or other such parties;
• infringement of local legal or regulatory requirements through lack of knowledge, translation errors, simple mistakes through making wrong choices regarding local partners, lawyers, agents, etc;
• fraud and corruption leading to vital equipment or other materials going missing;
• failing to obtain trade union agreements for proposed working practices.

Some or all of the above risks will need to be faced and dealt with (accepted, mitigated or declined). Some will be of great importance during the set up of the operations and less so once the operation is running while others will be ongoing. New risks will emerge once the operation is up and running particularly the people issues, such as staff turnover. In an emerging market, there will undoubtedly be many risks encountered which have not been experienced before in the developed world – corruption and religious differences being two obvious examples. Others are less obvious. Training people to deal with customers in other countries through adopting accents can lead to problems for them in their home environment, for instance.

The above list is fairly long but rather high level. We could drill down into each of the points raised and list many more specific risk areas to consider or could continue brainstorming and list many more possible risks. Just think of technology and start to list the things that might go wrong which could prevent computer systems being available to operators when they needed them – system crashes, data backup failure, data corruption, slow retrievals, search facilities not working, etc. If we did this, we would have a very lengthy list and would still not be sure we had covered everything.
An alternate approach is to categorize risks and assign specialists to look at each area of risk. The rationale behind this is that it is always easier to find something if you know what you are looking for.

**Categorizing risk**

We have raised the spectre of a more or less infinite range of possible risks. If this were the case we would have an impossible task in measuring, let alone managing them. This is not much different from trying to eat an elephant! It can be done, but only one small piece at a time. If a large issue can be broken down into bite size chunks then it becomes more digestible. The approach, therefore, is to use experts to look at the specific risks that apply to a given situation under various broad headings. In this way we can adopt a more systematic approach to identifying risks which will mean that:

- the probability of identifying the key risks in any situation is increased;
- the process of risk identification can be shortened through parallel working;
- a group discussion at the end of the initial review may well throw up additional risks, help understand linkages between risks and aid prioritizing the various risks.

![Fig 2.1 Business model](image-url)
Before listing the main risk types it will be useful to consider the framework within which businesses have to deal with risk. This is set out in Fig 2.1.

All businesses seek to earn rewards through taking risks. They do this by assessing the market opportunities with which they are faced and developing their company proposition (business model is another term for this) which sets out what product they will offer to whom and on what terms and how they will organize themselves internally to achieve this. If they are successful they will grow and expand, if not they will die. When a company is determining its proposition it needs to assess the market opportunity in detail. To do this it needs to understand the various factors which set the size and nature of demand and the degree of competition which they will have to face. The key areas are:

**Economic environment** – this includes factors such as interest rates, exchange rates, GDP growth rate, inflation, taxation levels, etc, which determine the size and growth potential of the economy. The domestic economic variables are the prime driver but for some economies global factors such as US dollar exchange and interest rates, commodity prices, export demand levels, etc, are also important. Global factors will play a larger part the more open an economy is. In recent years, this has been of growing importance for emerging markets.

**Physical resources** – the availability of primary or agriculture products and the size and nature of the physical geography of a country can help or hinder the development of the economy. Countries such as China and India are large and very diverse while Hong Kong and Singapore have developed with few resources.

**Social factors** – population size, education levels, work ethic, religion, social stability and other such factors determine the availability of labour and influence the levels of demand in the economy and its attractiveness as a production base and an outlet for sales.

**Political climate** – who runs the country, the degree of political freedom available, the size of the state in the economy and how stable it is will influence the attractiveness of a country for investors. Large democratic countries with a sound legal framework that protects business rights will obviously be more attractive than underdeveloped, autocratically run countries whose leaders seek to satisfy personal rather than national interests.

Using this model we can identify where the main types of risk which face businesses can be found:
The definitions of the various risk categories is set out in Table 2.1. We will be exploring each of these risk types in more depth in the next section.

### Table 2.1 Risk types

<table>
<thead>
<tr>
<th>Risk type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business risk</td>
<td>the risk of failing to achieve business targets due to inappropriate strategies, inadequate resources or changes in the economic or competitive environment.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>the risk that a counterparty may not pay amounts owed when they fall due.</td>
</tr>
<tr>
<td>Sovereign risk</td>
<td>the credit risk associated with lending to the government itself or a party guaranteed by the government (not to be confused with country risk).</td>
</tr>
<tr>
<td>Market risk</td>
<td>the risk of loss due to changes in market prices. This includes interest rate risk, foreign exchange risk, etc.</td>
</tr>
</tbody>
</table>
Table 2.1 continued

- commodity price risk
- share price risk

(it does not mean risk of falling demand in economic markets which is part of business risk).

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity risk</td>
<td>the risk that amounts due for payment cannot be paid due to a lack of available funds.</td>
</tr>
<tr>
<td>Operational risk</td>
<td>the risk of loss due to actions on or by people, processes, infrastructure or technology or similar which have an operational impact including fraudulent activities.</td>
</tr>
<tr>
<td>Accounting risk</td>
<td>the risk that financial records do not accurately reflect the financial position of an organization.</td>
</tr>
<tr>
<td>Country risk</td>
<td>the risk that a foreign currency will not be available to allow payments due to be paid because of a lack of foreign currency or the government rationing what is available.</td>
</tr>
<tr>
<td>Political risk</td>
<td>the risk that there will be a change in the political framework of the country.</td>
</tr>
<tr>
<td>Industry risk</td>
<td>the risk associated with operating in a particular industry.</td>
</tr>
<tr>
<td>Environmental risk</td>
<td>the risk that an organization may suffer loss as a result of environmental damage caused by themselves or others which impacts on their business.</td>
</tr>
<tr>
<td>Legal/regulatory risk</td>
<td>the risk of non-compliance with legal or regulatory requirements.</td>
</tr>
<tr>
<td>Systemic risk</td>
<td>the risk that a small event will produce unexpected consequences in local, regional or global systems not obviously connected with the source of the disturbance.</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>the risk that the reputation of an organization will be adversely affected.</td>
</tr>
</tbody>
</table>
Risk types

The main risk for any organisation is business risk. This relates to its ability to realize its business goals from the market opportunities available to it. As detailed above, this will include issues relating to:

- the sourcing of the material and other resources it needs;
- its capability to produce the goods or services it intends to sell;
- its ability to sell those goods and services (and recover monies owed from those it sells to).

All of these issues will be in the face of the competition and changes in the environment in which it operates. After business risk the main types of risk which companies face are generally considered to be credit, market and operational risks. For those operating in emerging markets, country and political risks will also be of particular importance. We will address the risk types in this order and look at the other risk types set out above thereafter.

Business risk

The video game market is dominated by a few players – Sony, Sega and Nintendo – who operate in a market which is as fierce and brutal as some of the games played on their machines.

Success requires continual investment in new gaming technology to deliver the fastest, most realistic games to players in order to “knock out” the current best performer. Achieving a return on this high level of investment can only be made, however, by gaining a high enough market share to sell sufficient games. To gain market share the games machines generally need to be sold as loss leaders.

Getting it wrong can be a costly business and the increasing cost of staying in the game is requiring these leading players to reassess their business strategies.

In Q4 2000, Sony launched its long awaited PlayStation2. Technically it was well ahead of current best performers but Sony's
The above example is not typical of most industries in that video gaming is a global market dominated by a few players but it clearly illustrates the business risk decisions facing senior management.

Companies and individuals take risks in order to make a profit. If they achieve profitability their business will grow and create wealth for the owners/shareholders and other stakeholders. Sometimes, however, it goes wrong. When this happens, is it due to management error or bad luck?

Our definition of business risk covers a wide range of possibilities that fall into both these categories, namely:

the risk of failing to achieve business targets due to inappropriate strategies, inadequate resources or changes in the economic or competitive environment.

Businesses get into trouble because wrong decisions are made by management, sound decisions are undermined by failing to provide adequate resources or circumstances change which have adverse consequences not
expected when the original decisions were made. The last could be con-
sidered bad luck but might be poor management due to a lack of
foresight. A good example is a company becoming unduly dependent on
one customer which places it at undue risk when its main customer comes
under pressure due to falling sales or a change in competitive factors. This
is known as concentration risk.

Footing the bill

During the early nineties, suppliers to global companies such as Nike and
Reebok in many emerging markets, particularly in Asia, got sucked into
the concentration risk trap.

Selling all or a large part of output to one or other of these two com-
panies was all very well while the total volume of trainer sales was
growing rapidly, but not only did the inevitable downturn in total sales
volumes come but new competitors in other emerging markets grew up
to compete for the shrinking volume of orders.

Quite quickly some businesses found themselves with significantly
lower orders and it was not long before several were in trouble as, not
surprisingly, orders were placed with companies who could deliver at the
lowest cost, provided quality and delivery capabilities were equivalent.
Those that did not fail immediately were badly hit when the Asian crisis
came along. Many failed due to over concentration risk.

Business models which are built on high fixed costs bases which are expected
to be covered by a high level of sales are another example of potential prob-
lems caused by management decision. Think of the Nike/Reebok example. If
they had decided to manufacture trainers in- house they would have needed
to expand their factory capacity rapidly in the nineties. Had they done this
they would have been faced with significant over capacity and would have
had financial problems as a result. The fact that they had sub-contracted pro-
duction to others meant they had passed this risk on to them. It was the
manufacturers in emerging markets such as Thailand and Indonesia that bore
the costs of lower production levels, not Nike and Reebok.

It is true that fully understanding business risks is a difficult area but it is
a key management role to ensure that they identify the key drivers for their
businesses and do a rigorous analysis of the companies’ vulnerability to any
of these changing. A good model to apply in this exercise is Porter’s Five Forces (see Competitive Strategy for a detailed discussion of this). Having undertaken this analysis, choices must be made and adequate resources provided to manage the associated risks. Here a major management failure is often to underestimate the level of inputs – financial, managerial, technical and manpower – required to support a particular strategy or initiative.

Another important requirement is flexibility as the world is constantly changing and it is often necessary to change either strategy or tactics or increase resource allocations, or all three, on a regular basis. This is definitely the case in emerging markets where unexpected changes are likely to occur quite frequently.

**Industry risk**

A risk closely associated with business risk is industry risk. This we have defined as:

the risk associated with operating in a particular industry.

In terms of the model set out in Fig 2.1 the choice of industry that you are going to operate in can be quite critical. There are a few key dimensions that are of importance when considering industry risk:

*Stage in the life cycle* – like many things industries have life cycles. They go through the stages of birth, growth, maturity and finally decline. It is clearly better to be in an industry that is in a growth phase rather than one that is mature or declining. We do not have to look far for examples of declining or sunset industries – coal, steel, shipbuilding, etc. Growth industries recently have been telecommunications and electronics but even these are slowing.

*Volatility* – volatility is a measure associated with change. A volatile industry is one where growth can change rapidly, up or down. Volatile industries involve greater uncertainty, making planning and decision making that more difficult. Volatile industries include electronics, software, real estate and construction.

*Degree of concentration* – the preferred position is to be a monopoly player in a protected industry much as the old state utilities were or the government run companies in communist states. Today the barriers are being broken down and industries are more competitive than they were as governments privatize, tariff barriers are lowered and new industries emerge which compete with
established ones. New technology, particularly the Internet, is a driver of change in this respect. As emerging markets have opened up to the world economy they are finding that cosy home monopolies are under threat. This is going to increase as they open up more under the terms of trade agreements and in accordance with requirements of the World Trade Organization.

All of these factors together with the economic, political and other factors set out above will help determine the market opportunities. Each company already in an industry must decide how to exploit their current position while those outside must decide whether to enter or not. It may well be the decision is that the industry risk is such that it should be avoided e.g. exit or do not enter.

When thinking of emerging markets industry risk may take on a different flavour. A sunset industry in a developed economy may be a sunrise one elsewhere, due to the different stages of development within the two countries. Indeed this may well be one of the main attractions of entering emerging markets, particularly those with larger and wealthier populations where pent up demand may be sizeable.

We shall return to this in Chapter 5 but let us move on to consider the more specific risks that businesses have to deal with once they have chosen which markets and industries they wish to do business in.

**Credit risk**

Most businesses produce goods or services which are delivered to the buyer and the buyer is allowed time to pay. This is termed as giving credit. Giving credit creates the risk of non payment. Credit risk is therefore:

\[
\text{the risk that a counterparty may not pay amounts owed when they fall due.}
\]

Determining who to give credit to and how much is one of the most critical decisions that a business manager undertakes and can often mean the difference between surviving and going bankrupt. The reason this is so important is that most businesses have only a modest profit margin on each deal done or product sold. Even if debts are paid eventually, the additional costs incurred during the period of the delay, or the costs needed to collect the debts, may be more than sufficient to wipe out the profit on the deal. This is particularly a problem for small businesses that are often paid late and can do little to recover these additional charges.
The risk of non-payment can become quite acute if in addition to late payment there is also concentration risk. Think of the second scenario we set up in the Introduction – a company taking on a large sized construction contract in an emerging market country. Construction contracts normally involve the completion of a number of stages. This generally takes quite some time so arrangements are made to make stage payments based on completion of various milestones. Payment delays are not uncommon, particularly where there are disputes over whether milestones have been reached or over the quality of work completed. In emerging markets many reasons, real or fictitious, are given for the failure to sign the necessary paperwork or, once signed, for the delays in payment as they wend their way through a seemingly interminable bureaucracy in one or more government departments. Signing authorities, for instance, are usually tightly controlled so it is not uncommon to be told that “the minister is away on business”.

Delay causes cashflow problems (see liquidity risk) and may impact on expected profitability (business risk) but the real problem occurs if payment never arrives. Many a company has embarked on “the job of a lifetime” only to find that the delays were so severe that they were crippled financially or that they never received payments due and went out of business as a result. Failure in these cases was usually due to concentration risk – too many eggs in one basket. *An important principal in risk management that we will return to more than once is – diversify to avoid concentration risks.*

Banking is an industry where this rule has been overlooked on many occasions to the regret of the bank’s management teams and shareholders. In banking, the line is particularly fine because margins are considerably smaller than those in industry, so it is even more important that credit decisions are made correctly a higher percentage of the time.

**Banking failures**

There are many examples of banks getting into trouble through over concentration in sectors which looked fine when things were growing but suddenly had problems when there was an unexpected downturn.

These include banks that over lent to oil sector companies and property developers in the US in the late eighties, small businesses in the UK in the early nineties and more recently lenders in the Asian economies and to those dependent on trade with Russia.

Many household names have disappeared as a result – Manufacturers Hanover Trust, Midland Bank, Continental Illinois, Security Pacific, etc.
For construction contracts in emerging markets, problems often arise because of financial difficulties that the country has. In most cases the contract is awarded by the government or a government owned entity. Unfortunately it is the case that, despite popular opinion otherwise, governments can and do default. This particular type of credit risk is given the name Sovereign Risk. This is defined as:

the credit risk associated with lending to the government itself or a party guaranteed by the government.

Sovereign risk is often confused with Country Risk, or even Political Risk, both of which are dealt with later on in this chapter.

Governments are of course only one type of counterparty that give rise to credit risk. Other types of counterparties that credit risk is associated with include companies, financial institutions, individuals, non-profit organizations and so on, etc. Our third scenario envisaged a company setting up a manufacturing operation in an emerging market country. Such an operation will undoubtedly have to deal with some if not all of these types of counterparties. Once it is up and running and has reached production stage, one of the biggest risks it will face in this regard is credit risk. Deciding who to grant credit to and how much, can be difficult in some developed countries but it is even more problematic in emerging markets where there is little credit information and what there is may be of little value. We shall come back to this in Chapter 7.

A risk often closely associated with credit risk is market risk.

**Market risk**

**Broken beliefs**

In 1997, many companies in Thailand became technically bankrupt because of a failure to hedge against possible exchange rate fluctuations. This arose because companies borrowed in US Dollars as, historically, the Thai Baht had fluctuated within a narrow band against the US Dollar and was considered to be pegged. The generally held view was that the peg would not break so it was considered a low risk to borrow in US Dollars rather than Thai Baht (an interest saving of 7–8 per cent) even where income sources were only in local currency.
Market risk is:

the risk of loss due to changes in market prices.

The main price risks that business will need to manage are interest rates, exchange rates and commodity prices. Property and share prices are less important but may need to be considered.

The above case study shows how the first two types of price risk, interest rate and exchange rate risk, can be interconnected. The incentive of reducing borrowing costs by half was considered worth carrying an unhedged exposure on exchange rate movements because past experience suggested that the probability of the peg breaking was very low. In reality, it turned out to be very much like the story of the Titanic. The possibility of the peg breaking was not fully appreciated so the consequences were not evaluated. As a result many companies followed the herd instinct and borrowed in “cheaper” US Dollars. When the unexpected occurred the consequences were catastrophic.

Market risk is potentially serious for our contractor scenario. When bids are made for a contract which is going to take quite some time to complete, assumptions must be made with regard to interest rates, exchange rates and raw materials (commodity) prices. Unless any changes in these prices can be fully passed on to the client then the contractor will bear those risks. As with most risks, the longer the time horizon the more difficult it is to predict accurately what values might be and, as we shall see, the possibilities for hedging these risks may well be less. There is another angle for our contractor to consider. The objective of taking on the contract is to make a profit. Even if he gets paid and his cost estimates were reasonably accurate he may still suffer from adverse exchange rate movements immediately before receiving payment. Given that the last payment is often held back to cover warranty periods, a sudden devaluation during that period could still significantly reduce expected returns.
Unfortunately many companies, even in developed countries, fail to appreciate market risks and take on quite significant risks sometimes in ignorance. As we have already mentioned, doing nothing is a risk decision. Failing to hedge risks means that you are actually accepting the open-ended risk that rates will move against you. You will clearly benefit if rates move in your favour but you will feel the downside loss more than the upside gain so it is better if you decide to accept these risks knowingly rather than in ignorance. A factor stopping some finance directors doing this is cost and personal credibility. If you take out a hedge and the current price on the date of the contract is better than the contracted rate, you may be accused of costing the company money. If rates move against the company it is easy to blame the market. Remember that the impact on you personally will influence your view of risk and affect the decisions you make. Better to be a live company with smaller profits than a dead one however!

A final word on market risk is that it is often confused with the risk of fluctuations in market demand rather than those associated with price movements. Care is needed, therefore, when using the word to ensure everyone has the same understanding of the term market risk as you do.

**Liquidity risk**

**Long-term credit management (LTCM)**

In 1998 LTCM, a hedge fund, was bailed out by banks arm-twisted by regulators in the US when it ran into a liquidity crisis which posed a significant threat to the stability of the financial system.

LTCM was established by a group of well educated and experienced market traders, including two Nobel prize winners. It sought to make money by taking positions in bond markets to produce small returns on large volumes. It was highly geared.

It managed its portfolio tightly through the use of sophisticated computer programs but there was a fatal flaw in their strategy. Their business was based on the assumption that when their computer program issued a sale instruction it would be possible to execute it and turn bond holdings into cash. Unfortunately this was not the case, liquidity had disappeared and a downward spiral ensued which left them with large losses very quickly.

External support provided a breathing space and the fund was eventually unwound with lower losses than would otherwise have been the case.
Liquidity risk is:

the risk that amounts due for payment cannot be paid due to a lack of available funds.

This is well illustrated by the LTCM story. The important point to appreciate is that even a company reporting satisfactory profits can go down quickly if a liquidity crisis occurs. This is especially true in the financial sector where some banks and financial institutions are over-reliant on interbank funding.

Meeting liabilities when they fall due is important to maintain credibility and customer confidence, as this will ensure that your credit standing will remain intact. Failure to settle on time is likely to mean credit will dry up, not only from the parties immediately affected but many other potential sources, as bad news travels fast in such circumstances.

When seeking to settle liabilities, a company has three sources of funds to draw on:

Existing cash balances – utilizing current account or readily available savings.

Borrowing – by drawing down pre agreed lines from banks, raising funds from company directors, borrowing from other group companies or issuing bonds.

Selling assets – liquid assets such as bonds and shares can generally be liquidated quickly, though maybe at a loss, while other assets, property for example, will usually take much longer.

A key responsibility of a company finance manager, therefore, is to ensure that there are sufficient funds available to meet immediate liabilities, allowing for any possible delays in receipt of funds from debtors, and there are fallback positions if problems arise. Failure to do so will leave the company extremely vulnerable in the event of a crisis.

Remember our contractor. He has to pay his bills on a regular basis, wages, suppliers, utility providers, etc, but contract receipts are generally quite lumpy. It may be two to three months between receiving contract payments and the finance director needs to ensure there are adequate funds to meet any payments that cannot be delayed. This can be a fine balancing act in some emerging markets where interest rates are high and bringing in funds from parents or associates may be unattractive. The manufacturer,
once established, should have less problems as cash inflows and outflows in that type of business are more evenly distributed. Payments for imported raw materials are likely to be more of a problem where exchange rates move against the company and raw material prices are volatile. In either case there is likely to be the need for larger financial buffers than would be the case in a developed market.

**Operational risk**

Operational risk is defined as:

> the risk of loss due to actions on or by people, processes, infrastructure or technology or similar which have an operational impact, including fraudulent activities.

This is one of the biggest areas of risk which most companies face but it is an area which has not traditionally been managed in an organized manner. For example, while many companies have had credit departments for a long time, few have had operational risk departments until the last decade or so. In addition there has been a tendency to consider operational risk as something which is closely associated with operations. This is now changing, partly as a result of the faster pace of change but also due to increased risk awareness.

Many of the risks identified for the call centre at the beginning of the chapter are operational in nature. We can group them together to aid understanding in broad sub-risk types. These include:

*Staff* – this covers all aspects of hiring, training, retaining and dismissing staff. The main issue is ensuring that there are sufficient people of the right calibre available and willing to undertake the tasks required of them. This includes senior management, who determine the strategic direction of a company and control the allocation of resources, through to the most junior staff level.

*Technology* – are the systems required to support business activities in place and available as and when required? How often do you get through to a call centre to find out “sorry, our systems are down”? Does this lead to loss of business or merely frustration for the caller? How does a company ensure that their systems are updated to meet business needs? The number and scale of technology risks increase almost daily.
Fraud – how can we protect our business from the possibility of fraud.

External dependencies – businesses are increasingly reliant on infrastructure providers, telephones, transport systems and power suppliers. How can they protect against possible disruption if any of these fail?

Processes/procedures – failure to set down requirements clearly may lead to incorrect actions being taken.

Another risk which is a more recent development is:

Outsourcing – originally this was seen as a cure for many ills, a way to reduce costs and part of the “returning to core competencies” trend. Now there is increasing concern over the loss of control which may result from contracting out some of a company’s key business processes, particularly where they use your name to provide services in your place.

Many of these issues are not new and most managers will have unconsciously or instinctively managed many of the risks for years, particularly the staff risks. The problem today is that the world has become more complex, more interconnected and the pace of change has increased to such an extent that new risks are occurring and they often have wide reaching consequences. This means that past experience may no longer be a useful guide to potential future problems. In addition, staff are becoming more demanding and turnover rates are increasing as people see jobs more as stepping stones than long term career moves. This increases risk quite considerably as businesses shift from manufacturing to services where the people factor is more important. The Internet and technology in its broadest sense have led to significant changes in how businesses operate as well as the development of entire new industries which has led to many more new operational risk – hacking, computer failure, misrouting of e-mail, etc.

All of these things exist in emerging markets but, in addition, there are new risks as well as new twists to familiar risks. Many of these are operational in nature. Let us consider a few of them.

Language/translation – while English is a common language used in business, particularly in trade situations, much needs to be done in the local language whether it be completion of legal documentation or simply giving instructions to manual workers. Translation errors and misunderstandings can easily occur as a result and can be quite costly.
Security – some emerging markets are unsafe and foreign companies and employees are obvious targets. There is a need, therefore, for security to protect company assets and personnel. This adds to costs, can make people feel uneasy, and may not even provide the level of protection expected. Problems may be internal rather than external – staff helping themselves to materials and supplies is not an uncommon activity which is difficult to control – so losses or shrinkage may well be much higher than experienced elsewhere.

Staff issues – in some countries, companies take on community responsibilities and are expected to provide accommodation, schooling, recreational facilities, roads, etc. Finding good staff may be problematic but getting rid of them if they do not perform as expected can be very difficult. If they have good benefits, including those listed above, they will not want to leave while labour laws may prevent their being made redundant or simply sacked.

There are many more such issues which have an effect on operational risks in emerging markets. We will return to them in more detail in Chapters 5 and 6.

Accounting risk

Polly Peck International

Polly Peck was the share of the eighties on the UK stock market. It was a trading and manufacturing group run by a Turkish born entrepreneur Asil Nader. It had operations in the UK, Turkey, Japan, the US and Turkish North Cyprus which included electronics, fruit packing, packaging materials, property investments and newspapers, amongst others. It grew organically and by acquisition throughout the eighties and produced increasing levels of returns which drove up its share price.

In September 1990, its share price collapsed. Administrators were appointed to wind up operations shortly thereafter. The company’s dealing were investigated and Asil Nader eventually fled to North Cyprus to avoid prosecution while shareholders and creditors were left with significant losses. What the investigators found was that the group had failed to account properly for currency conversions and had understated capital expenditures.
This case illustrates that accounting risk is:

the risk that financial records do not accurately reflect the financial position of an organization.

Essentially this means the accounts presented by the company do not represent a “true and fair” reflection of the company’s financial position. At one extreme this can be considered to be simply “creative accounting”, at the other it is fraudulent. Unfortunately Polly Peck is not an isolated case as the list set out in Table 2.2 clearly shows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Company name</th>
<th>What happened</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>British &amp; Commonwealth</td>
<td>acquisition in Atlantic Computers turned sour leading to write off of more than its acquisition cost.</td>
</tr>
<tr>
<td>1990</td>
<td>Coloroll</td>
<td>window dressing of balance sheet showed debt levels much lower than they really were.</td>
</tr>
<tr>
<td>1992</td>
<td>Maxwell Communications</td>
<td>illegal plundering of pension funds, selling of assets pledged to lenders.</td>
</tr>
<tr>
<td>2000</td>
<td>Transtec</td>
<td>failure to disclose substantial amounts in dispute with Ford meant profits were overstated for two or more years. Once discovered the company became insolvent and ceased trading.</td>
</tr>
</tbody>
</table>

In all the above cases, the companies either ceased trading or only survived by being rescued by third parties. All of them left a trail of bad debts and creditors either received no payment or only partial payment and then often many years later.
These examples are some of the more well publicized ones and they all relate to publicly listed companies. Well known auditors do not seem to be adequate protection against deception as several have been sued for negligence after high profile failures.

What about the rest of the listed companies? What of the unlisted ones? What about your own company’s accounts? The reality is that there are probably more cases of “creative” accounting which have gone undetected than the ones which have so far come to light. The three major sources of financial information are all suspect.

_Balance sheets_ – these are only snapshots of the financial position of a company determined at one point in the year using the accounting principles adopted by the company. It is easy to manipulate the numbers to make them look more flattering.

_Profit and loss statement_ – this is also to a large extent a discretionary statement which can be inflated or depressed to determine the desired tax situation of the company.

_Projections_ – these are prepared to show a favourable position and generally are not supported by clear assumptions nor are those assumptions rigorously tested.

Caution is required, therefore, when dealing with any financial information received whether audited or not. It is not always easy to spot potential problems but some of the telltale signs are:

- changes in accounting periods
- change of auditors
- qualifications in the accounts
- mergers and acquisitions
- revaluation of assets
- debt moved off balance sheet e.g. into offshore companies or special purpose vehicles
- exceptional and extraordinary items
- changed accounting principles
- structural changes in the companies included in consolidated accounts
- intercompany transactions.
Trends rather than absolute values, as well as looking at a number of ratios together rather than only looking at one or two key ones, can often help e.g. are profits going up in line with sales, is growth being financed by increasing debt which is supported by an adequate cashflow, etc. Care is needed, however, as reading financial statements is as much an art as a science, particularly when much is hidden in the notes to the accounts. This is even more important in emerging markets where international accounting standards are often not used, up to date accounts may not be required by law, and consolidated accounts are hard to come by. This lack of transparency is a significant problem, particularly when deciding on the granting of credit or trying to evaluate joint venture partners. Read Terry Smith’s book Accounting for Growth for a detailed explanation of the ways in which companies can and have misrepresented their true financial position.

**Country risk**

Country risk means:

> the risk that a foreign currency will not be available to allow payments due to be paid because of a lack of foreign currency or the government rationing that which is available.

In simpler language this means that a country either has no foreign currency or whatever foreign currency it has is not available, a not uncommon problem in some emerging markets.

This situation can arise for a variety of reasons such as:

- a decline in export earnings due to falling prices, lower volumes of exports or a reduction in supply due to crop failures;
- increased expenditure on imports either due to rising prices of essential imports or lack of controls on imports of non-essentials;
- the need to meet heavy interest or principal repayments on foreign currency loans;
- misappropriation.

Whatever the cause, the result is the same – companies and individuals in the affected country are no longer able to buy foreign exchange to meet their obligations. Some of the consequences are:

- the flow of imports is halted which may in turn mean it is no longer possible to produce goods for local consumption or export;
parallel markets develop with foreign currency being sold at much higher prices on the black market;
other financial problems result such as rapid devaluation, higher interest rates and rising inflation;
increased uncertainty;
halting of capital inflows and/or aid flows;
contagion – problems in one emerging market can easily flow through to others, particularly those in the same region.

If not addressed quickly, longer term problems result as investors shy away from the country and costs rise sharply. If vital commodities such as oil become short in supply, civil disturbance may then result.

Bad to worse

A recent example of economic mismanagement bringing a country close to collapse is Zimbabwe.

Policies and actions intended to keep President Mugabe in power have decimated the tobacco harvest and driven away tourists, two of the major sources of foreign exchange, while involvement in regional conflicts has drained precious reserves. Investors have shied away and even aid donors are wary.

The result has been an extreme shortage of foreign exchange and very little petrol is now available. People queue for hours but have no guarantee of getting any. The currency has devalued sharply and basic foodstuffs have gone up in price at a time when people are losing their jobs.

National strikes and civil disturbances are the order of the day with no end in sight unless there is a change of government.

Zimbabwe is somewhat of an extreme case, but it illustrates the point that where countries are dependent on a few sources such as exports, tourism or inward investment, they are vulnerable if those sources are impacted for whatever reason. Imagine you are halfway through your construction contract and you are not able to import the raw materials needed for the next stage. How are you going to progress and meet your contractual obligations? Unless there are get out clauses or the government releases reserves, delays will be inevitable and costs will rise.
As can be imagined, given the number of adverse consequences and the reputational damage done to the country, governments will seek to avoid these types of situations at almost any cost. There are usually warning signs and good risk managers will take steps early to protect themselves.

**Political risk**

Political risk is often associated with country risk. Country risk, in the sense defined above, is often a consequence of political risk. This we define as:

\[
\text{the risk that there will be a change in the political framework of the country.}
\]

Such a change could be positive rather than negative. Indeed, many emerging markets have seen positive trends e.g. the overthrow of communist regimes in Eastern Europe and the increased number of countries operating democratic processes in Africa and Asia. Unfortunately, just having a ballot box does not stop ruthless leaders gaining or staying in power even when they have obviously lost an election.

Countries such as the Philippines and Indonesia have seen the passage of power to populist leaders but this has failed to improve their economic situation. In both cases, leaders chosen by the ballot box have been removed from power as a result of claims of corruption. Both clung on to power leading to great uncertainty and problems for their countries. In other cases, peaceful transition has occurred.

What is needed in emerging markets is stable government which does the right things to improve the economy.

**Environmental risk**

Oil spills

One of the most publicized cases of environmental disaster was the Exxon Valdez oil tanker which ran aground off the Alaskan coast in the mid nineties.

The resulting oil spill caused considerable damage to wildlife and the coastline from which it has not fully recovered.

Apart from the adverse publicity Exxon was sued and paid fines and compensation running into hundreds of millions of dollars.
Environmental risk is something which has gained increased prominence in recent years, largely due to activists from the “green movement” who have managed to raise public awareness and concerns over damage to the environment which is either knowingly or unknowingly being caused by man’s activities. The definition of environmental risk is:

> the risk that an organization may suffer loss as a result of environmental damage caused by themselves or others which impact on their business.

What is of concern is both the direct impact that a business has on the environment but also the indirect ones it has through its interaction with its customers and suppliers. It may not be the production processes which cause environmental damage but the products themselves. CFCs from aerosols are a clear example where links were established between their use and ozone depletion, prompting manufacturers to switch to more environmentally friendly gases.

The direct impacts are usually fairly obvious – damage from oil spillage (as above), discharge into rivers, air pollution from chimneys, waste dumped in landfill sites, etc, but the indirect ones are not so obvious. These include things such as the sources of power used – electricity plants create air pollution or damage to rivers through hot water discharges – or problems caused when a company’s products reach the end of their useful life and disposal is problematic – car tyres or nuclear waste for example.

Indirect effects cannot be ignored, however. Banks have found themselves in difficulties as a result of:

- companies they have lent to have got into financial problems, due to environmental issues;
- foreclosing on loans and finding that the value of the security they have taken possession of is considerably diminished by their needing to bear the cost of cleaning up the property.

A more recent phenomenon is institutional investors setting up ethical funds which only invest in companies they consider are good citizens on the environmental front. This involves not only looking at how each company deals directly with the environment but also who their suppliers are and what their record is. This will become increasingly important in the coming years.
It is not only in developed countries that environmental risk has come to the fore in recent years, just think of the protests about logging in the Amazon and the rainforests of Borneo. These issues could easily arise in relation to the construction contract we have been thinking about — whether it be constructing oil pipelines, dams, roads or just a production plant. For any of these projects it is essential that a full environmental survey be done to avoid problems over displacing people, destruction of forest cover, pollution of rivers or the destruction of the habitat of rare species. All of these problems and more can occur. In emerging markets, protest may well not be as peaceful as in developed ones. Security risks can be significant, as well as the potential for project delays.

**Legal/compliance risk**

**Banking licence at risk**

In 1991 Credit Lyonnais, a French state bank, acquired the bond portfolio of Executive Life, a Californian insurance company which had got into trouble because of a sharp drop in the value of its investments. A complex structure was put together to undertake this purchase for which regulatory approval from both the insurance and banking regulators was obtained. Those approvals were given based on declarations made by Credit Lyonnais at the time.

Recently this transaction has been under investigation to determine if there were:

- one or more breaches of insurance law
- fraudulent actions by Credit Lyonnais management
- breaches of banking regulations.

If found guilty the consequences could be substantial for the organization. The most serious action could be the Federal Reserve stripping the bank of its operating licence. This would mean that Credit Lyonnais would have to wind up its US banking business completely.
Legal/compliance risk means:

the risk of non-compliance with legal or regulatory requirements.

The above case study illustrates the two sides of this – the need to comply with the laws of the land and regulations appropriate to your area of operations. In this case, insurance law and banking regulations.

Much of the law is general and will apply to all organizations e.g. employment law, health and safety, environmental legislation, etc. Others may be industry specific e.g. covering specific transport services such as railways or airlines. Regulations will generally be industry specific and will be issued by regulatory bodies having statutory powers over that industry.

A problem for most organizations is the volume and complexity of the law and regulations that have increased substantially in recent years. In addition, as operations have spread nationally and globally, complexity has increased as there may be multiple requirements which must be met. In the US, for instance, there is a complex web of national and state level legislation. In Europe there are national, local and European Union laws to comply with. It is not surprising that failures to comply may come about simply through ignorance though that is never an acceptable defence.

The concern for organizations, therefore, is the possible consequences of failure to comply. At one extreme they can be fairly mild – censure or rebuke – ranging to large fines or even closure at the other. For management there can be adverse consequences as some laws make them personally responsible, and fines or even jail sentences are not unheard of.

With the trend for more rather than less legislation and regulation and companies spreading globally at a faster pace, the probabilities of problems occurring is increasing significantly.

In emerging markets the level of legislation is increasing just as much as in the developed world and there can be just as bewildering an array of national, state and local laws and regulations to comply with. Setting up a call centre could require permissions from a large number of different departments and require infinite patience, or well placed incentives, to complete them all. Once up and running inspectors may call without notice and shut down operations for real or supposed infringements. Areas such as health and safety laws can cause problems, as can compliance with immigration laws where foreign workers are used. Overstaying residence visas or not getting work permits can cause significant problems for companies, situations they are not used to dealing with in their home countries.
In developed countries litigation risk, legal cases brought for real or spurious claims for damage caused by a company or its products, is increasing. As yet, this is a lesser risk in emerging markets but it is probably only a matter of time.

**Systemic risk**

**Y2K – the Millennium Bug**

The best example of systemic risk, or at least the threat of systemic risk, in recent years was the so called Millennium Bug. There was great concern across the globe that come the start of the year 2000 all sorts of systems which relied on technology involving date recognition would fail. Much was written about how systems would crash, utilities would fail and there would be panic or riots in the streets.

Much work was done to address this potential problem, but one of the issues encountered was the huge range of possible outcomes, potential risk scenarios were more or less endless and it was difficult to visualize how things were connected. Looking forward was like trying to follow the patterns created by throwing a handful of gravel into a millpond – virtually impossible.

The way this problem was approached was to seek to identify, in a systematic way, potential life threatening events, assessing their probability of occurring and their potential impact. From this analysis it was generally possible to find some order in chaos and focus limited resources on the key areas. The problem was that it was difficult to be objective and a large degree of judgement was required because of the uniqueness of the situation – no one had any prior experience of such an event.

The fact that limited problems actually occurred, or were publicized, does not mean that the bug issue was over-hyped, but represents a vindication of forward looking risk management practices.
The definition of systemic risk is:

the risk that a small event will produce unexpected consequences in local, regional or global systems not obviously connected with the source of the disturbance.

In the Y2K case, potential risks arose from a whole range of sources. What companies found in doing their analysis was that there were many more areas of risk that they had not focussed on before. Some of these were problematic, like finding that all your global communications go through one hub, but easily solvable, whereas others were simply problematic because they involved reliance on external parties that they could not influence.

At the individual company level, a good example of a systemic event having adverse consequences was the downfall of Barings. The trigger for the sequence of events that led to the demise of this long established merchant bank was the Kobe earthquake. This unexpected event caused the Tokyo stock market to fall 15 per cent in one day. The leveraged positions taken by Barings started running up losses which over a relatively short period escalated to several hundred of millions of dollars which led to the group collapsing. Barings of course collapsed not because of the earthquake but the fact it was unusually vulnerable due to the breakdown of basic risk controls which meant risk concentrations and liquidity problems were not clearly evident. (Unidentified risks were not managed.)

This later example shows how unforeseen and, at first glance, totally unconnected events can lead to unexpected and significant consequences. Spotting these potential risks is, not surprisingly, very difficult to do but is increasingly necessary. The underlying issue often is that better risk management would not have left companies exposed so that such events could cause them to collapse.

The greater degree of connectedness and the many more sources of potential problems that there are, mean that unexpected systemic events are more and more likely to occur and they will lead to increased problems for the unprepared.
Reputational risk

Watch what you say

During the late eighties and early nineties Gerald Ratner built up a chain of high street jewellers in the UK with hundreds of shops and a number of well known brand names.

In 1991 he made a speech at a business dinner in which he stated that there was more value in the prawn cocktail that they had eaten than in much of the jewellery that was on sale in his shops.

His light-hearted comments made headline news the next day. This adverse publicity seriously affected the reputation of his business and within 12 months he was forced to relinquish control as sales and profitability collapsed. The business was later acquired by another company at a knock down price after the share price, which peaked at £3.87 a share in 1987 fell to just 12 pence in August 1992.

Reputational risk is:

the risk that the reputation of an organization will be adversely affected.

The downside can be significant as the above example illustrates, because it can lead to a severe downturn in business and, in extreme cases, takeover or closure. In some cases this can be slow, in others it can be swift.

Slow decline often occurs through adverse rumour or publicity. This may not have immediately obvious consequences but a manufacturing company, for example, might see a decline in orders as its customers have concerns over the manufacturer’s ability to meet delivery dates. As sales decline, profitability and cashflow is impacted which may lead to more rumours and a downward spiral in orders and profits. In addition, providers of trade and bank credit may become concerned and tighten terms or withdraw support leading to possible liquidity problems. The downward spiral continues until there is concerted management action to reverse the trend, or business ceases.

In the financial services sector, reputation is extremely important and any adverse change can have serious consequences very quickly. A change in public confidence can lead to a run on a bank for example. Without support from other banks and the regulator, a bank can go under rapidly.
An important point to note from these examples is that the reputational risk is largely a secondary risk. *Reputational risk occurs principally as a result of failure to manage the other types of risk effectively* e.g. legal action for failing to comply with the law or protests by green activists in relation to environmental damage caused, often leads to adverse publicity. Some recent examples are Coca-Cola’s poor handling of contaminated cans in Belgium in 1999 and the outcry over Shell’s plans to dump a decommissioned oil platform in the North Sea in 1995. Perrier’s problems were similar though somewhat earlier. Interesting research shows that those companies which have been good at handling crises like these have actually not only returned to their former positions financially and reputationally, but enhanced them. This suggests that being open and honest and overreacting, recalling quickly and when not strictly required, is a better response than thinking short term cost or going into denial mode. This clearly shows how risk spawns opportunity.

In some respects, reputations can be less of a problem in emerging markets as foreign businesses are seen to be synonymous with good quality products. On the other hand, running across local cultural norms can lead to swift reaction. KFC and McDonald’s for instance have had problems in India over the use of animal fats in products where it was declared that they had not been used.

The most important thing to remember about reputation is that it can take a long time to build up, but a short time to destroy, so reputational risk is something that must be taken seriously at all levels in an organization.

**One risk or many?**

The previous section has covered in some detail some of the major categories of risk that businesses may face. These are useful categorizations but we must not lose sight of the fact that their use is a means to an end. Virtually every situation that we face will involve one or more of these types of risk. Understanding all the possible risks and managing them is a key management responsibility, as one of the major failings in risk identification is to think too simplistically and consider the task has been completed when the most obvious risk has been determined. Let’s think about our construction contract again. Some of the risks that the company might face are listed in Table 2.3. Some we have already mentioned.
As we can see, there are many possible risks in this situation. In the eighties in particular, there have been many cases of companies obtaining large contracts outside their home territory which were expected to make large profits but ended up leading to the companies’ demise due to one
or more of the above risks occurring. In Saudi Arabia for example, financial problems led to delays in payment, contracts being cancelled and many other problems. Banks that had lent money to Saudi companies found themselves in the Sharia courts where their claims for interest were declared illegal.

**Interconnected risks**

In addition to understanding that there are many risks involved in any one situation it is important to appreciate that the various risks are often interconnected. Figure 2.3 shows the connections between three of the major risk types – credit, market and operational risk.

![Diagram of risk connections](image)

**Fig 2.3** Linkages between the main risk types

Some of the linkages are:

- providing credit to customers involves market risk as funding is required. The cost of the funding may rise prior to settlement of the invoice which cannot be passed on to the customer;
- many customers will not pay until they receive an invoice so any operational delays in sending invoices or errors on the invoices themselves can increase credit and market risk;
- poorly trained customer relations staff may fail to deal with complaints effectively, leading to reputational damage.
Taking a wider view, we can expand this diagram to include the other main risk types as set out in Fig 2.4. It is important that such linkages are investigated and understood as it will help when deciding whether to take on risk and on what terms, and how risks can be managed thereafter.

Fig 2.4 Wider linkages between the main risk types

No risk?

Before going on to look at these risk types we need to consider one other possibility – that there is no risk. Is this possible? Have you seen some of the following offers in your national press or in TV adverts?

No risk!

Guaranteed return
Risk free investment
Sleep easy at night knowing your investments are safe

Like many advertising claims you need to read the small print. It is also useful to consider the old phrases:

“If it looks too good to be true, it probably is”
“There is no such thing as a free lunch”
There are two important points to make here.

*Nothing is risk free* – there will always be some risk in every situation even if the probability that the risk event would occur is extremely low. A good example is US government Treasury bonds. These are often quoted as risk free investments but this is not so, as the possibility will always exist that the US government might not be willing or able to pay its commitments. In early 1999, it nearly came to this when the failure to pass appropriate legislation on time meant that available funds were close to running out. In reality there would more likely than not be bigger issues to worry about before this situation arose, but we must not blind ourselves by ruling out the unthinkable.

*There are many types of risk* – Table 2.1 sets out a number of risk types. Not all are relevant to each situation but there are usually at least two to three major types of risk applicable to any activity. When people make statements such as “risk free”, more often than not they are thinking about only one type of risk or one possible risk event and failing to consider any others. Think back to the Titanic example. There were insufficient lifeboats because the builders and owners thought it could not sink. Did they not consider the possibility it could catch fire? Had that occurred, and they were in the middle of the Atlantic would they not have needed lifeboats for everyone?

The important thing to remember for now is that you must look beyond the obvious risk, particularly if it seems well covered. We do not mean to suggest, however, that there will always be a high level of risk, rather that there are probably other risks in any situation which you must ensure are adequately covered. This will be particularly true in emerging markets where things are often quite different from what they seem at first glance.

**Risk and life cycles**

Risk is something of a moving feast. This is due to the ever changing nature of the external environment but there are a number of circumstances in which risk follows a more orderly pattern or life cycle. A construction contract is just one of many such examples. It is often a large scale project which needs to be managed using project management methodologies. There is a clear start, middle and end involved and each of those stages have different risks associated with them that are generally predictable in nature.
Other examples of such life cycle type events are:

- the business cycle of buying raw materials, manufacturing, stocking, selling and recovering cash from debtors;
- banks providing long term loans to individuals or companies which are repaid in agreed instalments;
- any agricultural products which have an annual crop cycle;
- development and launching of new products;
- setting up and opening a new shop, bank branch, factory unit, etc.

The importance of this is that past experience of similar situations will make it easier to identify risks in the future. In addition, the various types of risk which are most important change as we move through the life cycle – assessing credit risk is important before a loan is granted, operational risk more important prior to funds being released and when payments are received. This is of increasing relevance in helping us to understand risk as the pace of change accelerates.

**Conclusion**

Companies succeed in business by taking risks, and getting it right most of the time. Even successful companies make mistakes or are hit by unexpected events but they survive because those mistakes or events are manageable. Being successful in your chosen field of operations starts with having a clear understanding of what the risks are that you face.

Whatever business you are in, there will be an almost limitless number of risks that you must face. To be able to manage these risks you must first identify them. Simply listing them is one way to do this but that may not help. The use of risk categories helps to provide a framework within which to look for, and latterly, to manage risks.

We have listed a number of the key risk categories that business face and covered them in some detail. Most of them will have been familiar to you, some may have been new. Whichever is the case, it is important to remember that all situations will involve many risk types, those various risk types are interlinked and beware of the salesperson that tells you there is no risk.

**Even successful companies make mistakes or are hit by unexpected events but they survive because those mistakes or events are manageable.**
Summary

The key messages from this chapter are:

- It is useful to group together risk issues in risk types to aid identification and bring expertise to bear.
- There are a number of generic risk types – we have covered a dozen of the most common ones.
- Most situations involve several risk types. Care is needed as it is often easy to focus on one prime risk and overlook others.
- There is no such thing as risk free.
- Risks which are not identified are unlikely to be managed.
- There are interconnections between most of the risk types which makes identification more difficult.
- Some types of risk operate in a life cycle.

References


CHAPTER 3

Measurement of risk

“Information is critical to the evaluation of risk”
ALAN GREENSPAN

Why measure risk?

Once we have identified the risks in a particular situation we need to consider how we can measure them. Why do we need to do this? The simple reason is that it is easier to talk more objectively about risk when there are numbers attached to it. As we have discussed earlier, there is a considerable amount of subjectivity involved in dealing with risk issues, so the more that subjectivity can be removed, the easier it will be to make meaningful decisions about risk issues. Once those decisions are made, the more objective data we have available the easier it will be for the impacts of those decisions, good or bad, to be tracked.

To achieve this objectivity we need to collect data, lots of it, but more importantly we need to convert it into information and then ensure that it is delivered to the right people at the right time in a way that helps them make better decisions. In an ideal world this would be done automatically and in real time, but we are far away from this in most organizations. In addition, even where good systems do exist they tend to focus only on part of the risk spectrum and ignore interrelated risks.

This chapter will cover the issues that arise in addressing the measurement and reporting of risk. This first one is, how easy is it to measure risk at all?
How easy is it to measure risk?

The short, but not very helpful, answer to this question is – it depends. It depends on what type of risk we are looking at and what aspect we are trying to measure, amongst other things.

**Risk types**

The first thing to consider is the risk type, as there are some types of risk that are relatively easy to measure, such as credit risk, and others that are much more difficult, such as reputational and systemic risk. Other risk types fall between these two extremes e.g. some aspects of operational risk can be measured relatively easily while others cannot. This is shown diagrammatically in Fig 3.1 which shows rough positionings only.

![Fig 3.1 Ease of measuring risk](image)

There is a clear linkage between this figure and the Uncertainty matrix in Table 1.1. This is reproduced below as Table 3.1. The risks which it is easiest to measure, such as credit and market risk, are those which align with the top row of the matrix – those where the range of possible outcomes is known and the probabilities are easier to determine. These appear towards the left of Fig 3.1. At the other end, systemic risk is hard to measure because it is difficult to pin down the range of possible events, let alone assign probabilities to them.

<table>
<thead>
<tr>
<th>Range of possible outcomes</th>
<th>Probability of an outcome occurring</th>
</tr>
</thead>
<tbody>
<tr>
<td>Known</td>
<td>Known</td>
</tr>
<tr>
<td>Known</td>
<td>Unknown</td>
</tr>
<tr>
<td>Unknown</td>
<td>Unknown</td>
</tr>
</tbody>
</table>
Table 3.2 covers the risks detailed in Chapter 2 and outlines the issues relevant to the measurement of risk for each one. There is a rough ordering from top to bottom in terms of ease of measurement. None are easy, but those towards the top are easier to put numbers to than those at the bottom.

<table>
<thead>
<tr>
<th>Risk type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market risk</td>
<td>there are sophisticated models which measure the extent of market risk but care is needed when dealing with outputs from complex models.</td>
</tr>
<tr>
<td>Liquidity risk</td>
<td>schedules of payments in and out in the immediate future should be available for most businesses together with a list of sources of funds which could be called upon at short notice. The longer the time period, however, the less the reliability of this data.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>it is easy to know how much credit you have given plus any interest accrued but not paid. What is often not known is any additional costs that will be incurred in recovery. Also rating the risk (probability of default) involves subjective as well as objective elements. Exposures in different currencies add an extra degree of uncertainty.</td>
</tr>
<tr>
<td>Sovereign risk</td>
<td>as a subset of credit risk, amounts due from governments will generally be known. However, determining the probability of default is even more fraught for government entities than other counterparties.</td>
</tr>
<tr>
<td>Country risk</td>
<td>information on exposures to various countries should be available but there are often definitional problems and time lags in data collection.</td>
</tr>
<tr>
<td>Industry risk</td>
<td>it is relatively easy to collect information about specific industries – size of market, growth rates, number of companies, etc – but less easy to put a number on potential developments such as innovation, regulatory change, etc which could fundamentally change prospects for the industry. Ranking is easier to do than defining an absolute measure of risk for each industry.</td>
</tr>
<tr>
<td>Classification</td>
<td>Description</td>
</tr>
<tr>
<td>-----------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Operational risk</td>
<td>Operational trigger points in manufacturing plants can usually be measured as can several areas of staff matters – overtime levels, number of vacancies unfilled, etc. Other areas such as vulnerability to fraud are not so easy to measure.</td>
</tr>
<tr>
<td>Business risk</td>
<td>It is relatively easy to dissect the main areas of activity of a business’s sales and the structure of its costs. This combined with macro economic data can give some idea of the vulnerability of the business to adverse change but there are many aspects to business risk which it is not easy to put a number on.</td>
</tr>
<tr>
<td>Accounting risk</td>
<td>Reliance on financial information from external parties can be determined. Dependency on the financial strength of one or a small number of counterparties (customers) will also be known. Quality of the financial information received is not that easy to determine however.</td>
</tr>
<tr>
<td>Environmental risk</td>
<td>It is possible to measure the level of certain types of emissions but some areas of environmental risk are problematic, especially where their impact is evident only some time later e.g. asbestos claims or acid rain fall out.</td>
</tr>
<tr>
<td>Political risk</td>
<td>It is relatively easy to identify those countries where political risk is higher but not so easy to put objective numbers against it. Again, rankings rather than absolute measures are easier to define.</td>
</tr>
<tr>
<td>Legal/compliance risk</td>
<td>Impact of non-compliance is often readily evident, fines received for instance, but it is difficult to measure vulnerability to it.</td>
</tr>
<tr>
<td>Reputational risk</td>
<td>As with legal and compliance, measurement is difficult until after the event and even then not easy.</td>
</tr>
<tr>
<td>Systemic risk</td>
<td>Given its very nature it is more or less impossible to measure systemic risk.</td>
</tr>
</tbody>
</table>
The ability to measure risk in developed countries is clearly more advanced than in emerging markets. There are various reasons for this that we will explore later in this chapter and in Chapter 5.

**How many risks?**

Returning to the measurement of risk it is important to appreciate that the comments in the above table relate to the measurement of single risk types. It is more difficult to look at the measurement of interrelated risks. The greater the number of risks involved the more difficult it becomes, e.g. a loan in foreign currency is known as the amount of principal due in the currency of borrowing (credit risk) but is not fixed in local currency equivalent (market risk), interest due is vulnerable to interest rate movements (market risk) and there are risks related to the processing of loan payments and documentation of the loan facilities (operational risk). Putting together a clear and reliable number to take into account all of these risks is not something that it is easy to do at the moment.

**Time**

Another complication when measuring risk is time. The further we look ahead, the more unreliable measures become as predictions of future values are dependent on:

- the starting point
- assumptions about changes in key parameters
- correctly predicting events that might impact on risk.

Taking the above foreign currency loan example, the further we look ahead the more difficult it will be to estimate the level of risk due as exchange rate and interest rate changes become less easy to predict. Similarly, for our construction contract the longer the contract is due to run, the more difficult it will be to predict what risks may arise, let alone measure them.

**Individual versus portfolio risk**

The points we have covered so far relate to the risk or risks associated with a single situation e.g. a foreign currency loan. Another way to look at risk
is to assess the risk of a portfolio – remember diversification is an important way to manage risk. This is generally the best way to look at situations where there are a large number of individual risks e.g. in the insurance or finance industries. The whole basis of the insurance industry, after all, is pooling and managing risk in the aggregate.

There are two approaches to measuring risk for a portfolio:

- assess risk for each component and sum up the risks (bottom up);
- measure risk for the portfolio level (top down).

Which is chosen will be determined by the nature of the risk and the costs involved. In the banking industry, for example, there is a clear divide between how credit risk for corporate and consumer portfolios are calculated. Corporate customers are large in size and few in number, so risk at individual customer level is assessed and the level of overall risk is determined by adding up the individual risks. Individual customers, on the other hand, are many in number and small in size so top down measures to determine the riskiness of the whole portfolio are used because to do otherwise would be too costly.

The main problem with both these approaches is that they are simply looking at the aggregate risk for one type of risk. There are problems in doing this as we have explained, but it is even more problematic to try and aggregate risks across the risk types. Across economies, money is used to determine the value of assets and liabilities, or to price goods. To date, there is no equivalent currency for measuring risk though some would argue that Value at Risk measures (see Market risk) offer a possible approach. To find such a measure is the holy grail of risk measurement.

Let us now consider some of the common types of risk measurements used.

### Common types of risk measures

#### Basic measures

*General* – the simplest measures are sometimes the easiest to gather and analyze. These include:

- absolute values – size of debtors, stocks, number of transactions processed, number of staff absent, system time available for use, number of units of production made this shift, etc;
- ratios – comparison of two values e.g. percentage of each individual debtor to total debtors to measure concentration risk;
- trends – percentage change in absolute values over time;
- milestone or Gantt charts. Reporting actual versus expected positions and measuring the gap between them can give a measure of risk.

**Business risk** – there are no industry standards for measuring business risk. What each company’s management team needs to decide is what the critical success factors are for their business in their chosen market and develop a reporting pack which captures relevant information. These could include some of the specific measures detailed above as well as those discussed below.

These critical success factors might relate to a variety of areas of business activity and could include things such as ensuring continuing supply of raw materials at acceptable prices, keeping production levels running at or close to capacity, minimizing the level of stocks throughout the production process, recruiting and keeping suitably qualified staff, maintaining or increasing market share, translating research development (R&D) into a stream of successful new products, ensuring access to adequate funding sources, etc.

Some of the key measures that might be used to monitor company-wide business risks could therefore include:

- **Financial measures** – interest and exchange rates, current and forecast. These are of little value on their own so it is important to combine these with internal measures indicating vulnerability to movement in the key rates e.g. the level of debt and anticipated foreign currency income and expenditures.
- **Market developments** – actual and expected GDP growth rates in key markets.
- **Commodities** – prices of key input e.g. oil prices.
- **Production** – actual production versus break-even levels, capacity utilization, measures of production quality such as reject rates, etc.
- **Sales levels** – actual versus expected, trends by products, market share.
- **Competition** – new entrants or departures, new product launches, etc.

There are a large number of factors that could be used. One measure alone will be insufficient to help understand increased or reduced levels of business risk but a report which monitors a relatively modest number of key factors, no
more than 10 to 12, will go a long way to helping senior managers get a good handle on the overall level of risk facing their business.

Where companies operate internationally, and especially those operating in emerging markets, these key factors will need to be expanded to include a wide variety of measures.

**Specific measures**

**Credit risk**

Credit ratings – these are given by ratings agencies such as S&P and Moody’s and give an indication of the riskiness of a bond issue. The best rating, AAA or “triple A”, is given to bonds with a very low probability of default. Lower ratings, A, BB, BBB etc., are given as perceived risk increases. Bonds rated AAA to BBB- are considered investment grade while those with lower ratings are considered “junk bonds”. Risk levels rise exponentially as illustrated in Fig 3.2. Needless to say the level of return required to attract investors increases as the level of risk increases. Such ratings are given to companies, financial institutions and governments. Counterparties domiciled in emerging market countries generally have risk ratings on the right hand side of the diagram which is a measure of the greater risk in extending credit in such environments.

\[
EL = \text{Probability of default} \times \text{size of limits} \times \text{loss given default}
\]

**Expected loss (EL)** – this is a measure of the loss expected in a portfolio over an economic cycle. It is determined by use of the following formula:
The probability of default is determined by the credit rating and the loss given default (LGD) will be determined primarily by the level of security held. EL will be lower, therefore, where funds are advanced to better credit rated counterparties and/or a good level of security is held.

EL can be considered as a cost of doing business as it is more or less inevitable that some debtors will not pay part or all of the amounts of money they owe. The problem is that we do not know which counterparty will not pay nor when (if we did we would not grant them credit). The EL measured is an average. Actual charges against profit and loss will vary year to year. This concept is well developed within the financial services sector but applies equally to all businesses who provide trade credit. In emerging markets it is difficult to determine the credit rating of counterparties, even with listed companies, as few have external ratings. When dealing with trade credit the rule is only to give low values of credit and build it up over time, and avoid concentration risks because measures such as EL are not easily applied. If EL can be measured in emerging markets it is likely to be higher than in developed markets as credit quality is generally lower.

*Unexpected loss (UL)* – this represents the volatility of losses. The higher the EL the higher the UL. The relationship between EL and UL is represented in Fig 3.3.

Expected losses are the cost of doing business, sometimes called a business-as-usual (bau) cost. Unexpected losses are determined by the degree of volatility and are usually measured at five to six standard deviations from the
mean value. Unexpected losses may occur, say once in ten years, and a company protects itself against such events by maintaining an adequate level of capital. The more volatile the environment the more capital required, which clearly applies to those companies doing business in emerging markets. Volatility, however, does not fit well with market expectations for rising but stable profit levels. Operating in emerging markets will increase volatility of earnings unless well managed.

To complete the picture we should mention catastrophic loss. This is the “extreme event” that can appear on the far right of the loss curve. Companies cannot usually keep sufficient capital to cover such events, as it is too costly, but may seek to insure against it as we will discuss in Chapter 4.

**Market risk**

Value at Risk (VaR) – VaR is a risk measure which indicates the maximum loss on any one day for a given probability of loss e.g. a VaR figure of USD 1 million with 95 per cent confidence indicates that on 95 days out of 100 the maximum loss from market movements would be no more than USD 1 million.

VaR is a measure which has developed rapidly in the nineties as a concept, particularly as it is a useful way of aggregating risks across a variety of assets exposed to market risks. Care is needed in using VaR as it does have limitations.

VaR can also be used to measure credit risk but so far such measures are not as common as EL/UL ones.

**Liquidity risk**

Liquidity is all about having cash available when needed. Simple measures, particularly for smaller organizations, may be all that is needed e.g. a cash-flow chart showing expected inflows and outflows plus available bank lines.

**Operational risk**

Much effort has been given in recent years to developing specific measures of operational risk. To date there is no universally accepted measure along the lines of VaR so much of the risk continues to be measured through traditional means. As we have mentioned, operational risks cover a wide range of areas each of which has a different degree of difficulty in the measurement stakes. Some of the more typical measures are:

- **Staff** – number of vacancies, absolute numbers and as a percentage, period jobs unfilled, average and maximum numbers of staff absent, levels of overtime etc.
• Operations – percentage of capacity used, instances of control limits being exceeded, number of times systems were not available, levels of emissions, number of items unprocessed at end of day, transaction volumes, average processing time, maximum processing time, productivity levels, staff turnover, number of processing errors per thousand, outstanding reconciliations, etc.

• Fraud – number and value of instances of fraud or attempted fraud, number of attempts to breach security systems.

• Risk Self Assessments (RSAs) – these are questionnaires used at various levels in an organization by management whereby each individual undertakes an assessment of his/her area of responsibility by working through a series of generic questions. These may cover things such as staffing levels, identification of current known problems, adequacy of technical support and planned changes due in the next 6/12 months. Risks are rated and priorities attached as a basis for resource allocation after discussion with the next level of management – high for particularly significant risk areas, medium for less significant risks and low for those with limited impact.

Other than RSAs, some of the above listed data may be fed into ratings systems that use a mix of objective and subjective criteria to work out a risk score for a particular business unit or operational area. Some systems involve broader risk categorizations and use red, yellow and green colours to signify degrees of concern or high, medium and low risk categorizations e.g. reporting on milestone achievements against a project plan. The intention of these risk-rating mechanisms is to help determine priorities for action but different people will always have a different view, for reasons we have explained in Chapter 1, and things can get overlooked or downplayed. In addition, there can be a perverse incentive to underrate risks if any high risk requires the manager highlighting it to undertake additional work.

An alternate approach is the use of key risk indicators (KRIs). KRIs are objective measures set by management which are considered to be worthy of regular tracking because they are considered leading indicators of risk e.g. number of staff who have not taken a defined period of continuous leave (a means of minimizing the risk of being hit by internal fraud).

Many of the risks in the call centre example are of an operational nature so these and other types of risk measurements are things that could and should be used to measure levels of risk on a more or less constant basis. They need not necessarily be sophisticated measures but if used properly can be most helpful in highlighting potential problem areas early enough so that action can be taken.
Reputational risk

Customer surveys can be done to assess current reputation and highlight possible areas of concern amongst respondents. For call centres the ability to answer calls quickly and efficiently will impact on the organization’s reputation. Being held in a call queue for a long time and then being given poor service can undermine a company’s reputation quite quickly. This is an increasing risk where many basic services are outsourced, because there is less control over what third parties do although they are acting of your behalf. Press comment can also be tracked to identify the number of positive and negative reports.

The above are just a few of the many measures that can be used but all of them require good quality data to be available in sufficient quantity and at the right time.

Multiple measures

The above gives just a hint of the variety of risk measures that are available today for evaluating and reporting risk. In practice we need to use a variety of such measures when looking at risk as no one single number is ever going to be sufficient. This is because most, if not all, risk measures have limitations.

Having more than one measure will allow comparisons to be made between the various measures. Hopefully this will throw up inconsistencies which will lead to enquiries to identify possible causes or potential problems which otherwise might not have come to light.

See the various articles in Pickford’s *Mastering Risk* and Culp’s *The Risk Management Process* for a more detailed and technical discussion of risk measures and their associated benefits/limitations.

Data versus information

Most organizations have a lot of data but rarely do they have sufficient information. The key difference between the two is that information provides some value to the recipient which can be used to make decisions. Information is created by taking raw data and analyzing and transforming it in some way to make it more useful. The following example illustrates the difference.
Table 3.3 simply lists the amounts that are owed to a company by its customers. This has limited value as it only tells you the total amount due. Table 3.4 breaks down this data to show the period various amounts have been outstanding and how the total due compares with the credit limit set for each customer. This more detailed analysis means that the company credit manager can quickly identify those customers who have not paid promptly – Corner Inc and Geoff’s Builders – and those which are in excess of the credit limits – Geoff’s Builders. Having identified these customers as potential problems, action can be taken to chase up for payment or stop delivery of goods until arrears are cleared.
For companies with a very large number of customers, the second table might not be the most useful format. To address this it would be relatively easy to refine it further and only report those accounts with amounts due for more than 90 days and those in excess of limits. Raw data such as Table 3.3 is readily produced by most computer systems but turning it into management information requires additional programming. These days it is not overly difficult to turn raw data into information through the use of report functions in operating systems or desktop PCs. Producing information may be easier to do today, but this will only happen when users have clearly defined their needs. More often than not you will hear managers complaining that they do not have the information they need, but ask them what they really want and they are unable to tell you.

In today’s environment, managers not only need to be clear about the types of risks that they face but also about what information they need to measure those risks. For companies with a very large number of customers, the second table might not be the most useful format. To address this it would be relatively easy to refine it further and only report those accounts with amounts due for more than 90 days and those in excess of limits. Raw data such as Table 3.3 is readily produced by most computer systems but turning it into management information requires additional programming. These days it is not overly difficult to turn raw data into information through the use of report functions in operating systems or desktop PCs. Producing information may be easier to do today, but this will only happen when users have clearly defined their needs. More often than not you will hear managers complaining that they do not have the information they need, but ask them what they really want and they are unable to tell you.

In today’s environment, managers not only need to be clear about the types of risks that they face but also about what information they need to measure those risks. This requires clear thinking and some degree of creativity. It may also require persistence because there are unlikely to be sufficient funds available to meet users needs so they must lobby hard or fund development work themselves. Time, technology and resources are constraints but the major issue is usually the quality and quantity of data. However, the old adage remains true “rubbish in, rubbish out”, so even if you do specify your information needs clearly and reports are built-up, this is no guarantee that the information you received is of any value. Let us consider the key data issues.

Data collection

**Internal sources**

Data is created all day every day by all organizations. In the call centre operations we have been considering, the following sorts of data would be created:

- purpose of each call – whether it be a simple enquiry, a quotation or a sale;
- calls – number processed, time taken to answer, wait times for callers;
- people – number of people on duty for each time period during the day;
- technology availability – details of any systems downtime.

Such data can be turned into useful information by comparing the efficiency of call processing at different times of the day with the number of people on duty, or producing performance tables to see how individual operators compare to the average or best performers. This information can then be used to adjust staff levels to anticipated demand and to reward good, or penalize poor performers. To do this it is necessary to ensure that:

- the required data is captured at source
- data is accurately recorded
- data is properly coded
- data histories go back far enough.

For a set up such as a call centre, data is likely to be available because call centres are relatively new, they are dependent on technology, and data collection/analysis has been built in as an essential business requirement from day one. For longer established businesses and particularly those which operate over a number of locations, it is unlikely that all required data will be available both in terms of quality and quantity. In emerging markets much processing remains paper based making data retrieval almost impossible. For businesses operating in several emerging market countries this will produce a logistical nightmare.

There are a variety of problems with data collection internally, which can be grouped under a few key headings as follows.

Data standards and coverage
- data standards are not always well established e.g. naming conventions, group identifiers, etc;
- data is generally collected from processing systems but not all required information may be available electronically;
- it is easy to collect “hard” data on areas such as sales but not on “soft” areas such as customer satisfaction;
- time series data may be short or broken.
Technology

- multiple systems may be in use which contain different values for the same data item;
- technical constraints – not all systems talk to each other so it is not uncommon for data to be printed out from one system and then re-entered manually into another;
- programming inefficiencies e.g. data entry fields without proper validation routines which allow, for example, blank entries or dates that do not exist;
- capacity may be insufficient to keep all required data for a long enough period.

People issues

- there are few incentives for data entry staff to get it right;
- changes in data do not always get updated;
- there are often inadequate checks on data entry even where standards do exist – errors not corrected at entry will corrupt any data analysis.

At the most basic level, information for managing risk is usually a by-product of a processing system designed for a completely different purpose and there is often insufficient policing of the quality of data going in at the front end of the system so the value of information produced is undermined. Most of the above issues are recognized by management but addressing them effectively is generally a problem because it requires considerable time, effort and substantial resources – both financial and personnel – to resolve.

The recent increase in merger and acquisitions activity is making the problem worse. In such situations the priority is usually moving the combined organization onto one platform which means ongoing problems are not always addressed – poor data is simply migrated from one system to another. In some cases multiple operating systems remain in place making reporting even more problematic.

Other complications arise where businesses operate cross border. These include:

- use of different currencies/languages;
- the need to meet local and head office reporting requirements;
- data aggregation – consolidation of reporting is required at the centre.
The ideal would be to have one system which can be used globally by all units but this is not always feasible though there has been a trend amongst larger organizations to operate hub and spoke arrangements where a regional centre processes data for a number of countries.

A further development in recent times has been the establishment of data warehouses which are used to store large volumes of data that previously were lost due to the inadequate storage capacity in transaction processing systems.

**External sources**

Most of what has been covered in the previous section relates to internal data problems. These can be addressed in part by the use of external information. This is more and more readily available, for free or for a payment, and in a variety of forms. The volume is now quite staggering, as an Internet search will quickly confirm. Speed of delivery has also been enhanced. Available sources include Reuters and Bloomberg's for up to date market information; credit information is available from ratings agencies such as Standard & Poors and Moody's. There are many other sources of information including government websites and those of international agencies such at the World Bank and the International Finance Corporation, United Nations, etc or publications such as *The Economist*.

The above detailed improvements in quantity do not necessarily mean that the issues of quality are entirely overcome. For services for which payment is made we would, however, expect to see some quality controls in place e.g. credit bureau data. A further complication is that legislation has been introduced which restricts the free use of some information in many countries. This has been driven by concerns over privacy. For emerging markets, however, coverage often remains thin and delivery times slow.

**Data analysis and risk measurement**

Data can be turned into information through the application of data analysis techniques. If these are automated and properly programmed, risk measurement can be significantly enhanced. The speed with which computer and communications technology has developed has undoubtedly enhanced capabilities but many organizations still do not have the level of sophistication that they would like.
We have mentioned the development of data warehouses but it has proved to be more difficult to extract meaningful information from the large volumes of data collected than was anticipated. This is in part due to the above listed data problems but it is also due to the lack of skills – programmers do not know enough about business, and business people do not know enough about programming.

Where useful information has been drawn from data warehouses it has largely been driven by sales initiatives e.g. by allowing more targeted mail shot campaigns. Well established dot coms such as Amazon are experts at the use of these techniques but such organizations are few and far between. Much less use has been made of data warehouse information to look at risk issues. One exception is the financial service industry where significant levels of data are required to drive sophisticated credit and market risk models. Even this often has a sales flavour e.g. undertaking credit pre-screening before sending credit card or unsecured loan solicitations.

Even where there are good risk reporting systems in place they generally only cover those areas of risk that lend themselves well to numerical analysis e.g. credit, market, country/sovereign risk and some areas of operational and environmental risk. Examples of the latter are call centres (see above) or manufacturing operations where data on volumes of production, defects per thousand, tolerance level excesses, emission levels, etc are readily available. Other areas are problematic. Here, information is largely anecdotal or written rather than numerical, and thus remains rather subjective and difficult to analyze in a meaningful manner. Even where work is done to fill some of the gaps, through customer surveys for example, getting meaningful information is difficult to collate because of errors in sampling, bias or untruthful answers. Aggregation of data in a written format is difficult.

Another problem is timeliness. Information is only useful when available at a point where you have sufficient time to take action. If it arrives too late then it is of little or no value at all. Technology has again been a great help, as it is now possible to find out what is going on from far away through interrogation of computer systems or find out answers to queries with a quick e-mail, but these options are not always readily available.

A common problem with data analysis and reporting is that it is generally behind the times. Often we report today the data and risk measures which have been developed to deal with yesterday’s risks. The other danger is that people only look at the information fed to them by reporting systems. Failure to update risk measures and reporting, and recipients not keeping an open mind on what they need to look at can lead to problems.
How can we ensure that the risk measures that we are reporting are those that are most appropriate?

Take key risk indicators (KRIs). The value of KRIs is in providing information which can suggest to management potential problems before they arise e.g. increased absenteeism, rising transaction volumes, increased levels of unprocessed items at the end of day, etc. They aim to be forward looking.

KRIs are, however, only of value if they are appropriate to the business operation being reviewed and they are kept up to date.

If you add an Internet delivery channel to the existing channels but do not expand the scope of the KRIs it is unlikely that you are going to be in a position to appreciate any potential problems arising in your Internet support area.

We must not forget also that obtaining information involves a cost and that like most things in business there is a trade-off between information acquisition costs and the quality and/or quantity of data received. Apart from regulatory information (or demands from head office) for which there is, usually, no choice on whether to provide or not, management must look carefully at what their needs are, what resources are available and the possible consequences of not having information. Given that it is difficult to put a precise value on information it is hard to determine the benefits of having it. Equally it is hard to say that not having it increases the possibility of a major loss. Cost cutting exercises are a concern here as they tend to go for soft targets which include back office functions producing information rather than sales revenue. Short term cost cutting can easily lead to increased risks long term.

Cost cutting exercises generally do not generate the long term savings that are expected of them even when those savings are publicly announced.
Model risk
Risk models are used to measure the current level of risk in a given situation or the possible level of risk in the future. Default probability models for credit risk, for instance, assess the likelihood that a counterparty will default over the coming 12 months based on a variety of data run through a scorecard of some sort or another. Scorecards are built using past data and statistical techniques to best fit outputs to historical results. Value at Risk is similarly calculated by using a model back tested against past data. Care is needed however to ensure that users are well aware of the risks in using such models as it is easy to place too much faith in such “black boxes”.

Some of the issues with these and other risk models are:

- models are only an approximation of the real world;
- assumptions or formulae used may be incorrect;
- they assume the future will behave in a similar way to the past;
- they may be incorrectly programmed;
- validation requires good quality data for a lengthy period;
- apparent statistical linkages can be spurious.

To address these issues it is important that models are developed by staff with the requisite skill sets and that they are revalidated on a regular basis, particularly given the fast pace of change in the modern world. Revalidation should preferably be carried out by an independent team, possibility outside experts, with input from business users of those models.
Business users have an important role to play here as they can perform “reality tests” on model outputs to ensure they make sense and will be of value. This will help avoid problems arising from “those guys in Head Office” developing tools that are then imposed on people in the field.

To assist in validation it is critical that there be a stock of good quality data available for an adequate time period. Data quality, as we have already explained, is a potential problem. Additional potential problems are breaks in time series, the rebasing of data and changes in data definitions.

In addition to addressing the above technical issues, it is as important to ensure that the people who are going to use the models are given sufficient training to understand how they work, what inputs are required and how outputs should be interpreted. Misuse of outputs is as much a problem as poor data inputs and can be a particular problem when transporting models and risk measures cross the border into new environments such as emerging markets.

**Reporting**

**Content**

It is of great importance to obtain good quality data and then turn it into useful information. The third important step is to deliver that information to the most appropriate person or persons at the appropriate time and in the most meaningful format.

As we have explained above it is important to turn raw data into useful information. The test of usefulness will be whether the information aids the recipient in understanding actual or potential risks quickly and more efficiently than other methods, and helps in making the correct decision. To be useful in this way, reports should:

- provide information which highlights actual or potential risks in a clear and unambiguous manner;
- give some indication of the probability of an event occurring;
- indicate the potential or actual size of any impact;
- be delivered in the most efficient manner;
- provide the level of detail which is necessary for the recipient to make a decision taking into account his/her level of prior knowledge and expertise;
- suggest appropriate actions and recommend a course of action with reasons.
All of the above criteria are only likely to be met in a detailed report providing analysis and commentary on a particular situation or risk event of sufficient size that it warrants such level of detail e.g. a project report or result of a specific investigation. The simplest report should, however, seek to meet the above criteria as far as possible e.g. a daily production report should not simply deliver a vast amount of data but a short summary of key information to the main production unit managers at the end of each day or, at worst, the beginning of the next day highlighting any risk areas.

**Types of report**

There are a variety of ways in which actual or potential risks can be reported. These include:

- verbal or written reports providing risk data with or without analysis/conclusions;
- exception/excess reports highlighting items outside predetermined boundaries;
- project updates showing milestone achievements, targets not met, etc;
- financial reports including balance sheet, profit and loss and future projections plus key ratio analysis;
- risk rating scorecards;
- risk self assessments;
- outputs from scenario plans and/or stress testing/simulation outputs;
- internal/external audit reports;
- graphical presentations – pie charts, histograms, time series data, etc.

There are a large variety of options but thought must be given to the most appropriate format to achieve the goals set out above.

**Most appropriate format**

The most appropriate reporting method to use will be determined by:

- the nature of the risk
- probability of an impact occurring
- size of potential impact
- who the recipient is
- where the recipient is located
- speed with which information must be conveyed.

However, the optimum solution may not be the one executed due to limitations of resources, technology or time available. In some cases, an event may have already occurred and the need is one of damage limitation. In such cases, the requirement is usually the maximum information in the shortest time possible.

In an emergency, short verbal reports followed up by more information will usually achieve the best results. The results of a long term study, however, would best be contained in a detailed and probably formal report.

A key issue will always be understanding the frame of reference of the recipient. An experienced senior manager will usually want less information because his experience will generally allow him to assess the risk issues more quickly and decide on the appropriate course of action, in addition to which he is likely to be busy and has insufficient time to review long and complex reports. A more junior manager may well need more information to get to the same conclusion.

**Frequency of reporting**

Similar factors as those set out above will influence how often risk reporting is necessary. The time factor will be more or less important depending on what situation we are dealing with. In a bank dealing room it is vital to have real time data on current positions and prices so action can be taken quickly to close down positions if events do not go as expected. For businesses involved in continuous or dangerous processes, a constant flow of information on critical areas at risk will likewise be needed. In contrast, the amount owed to a company by an individual customer is something that can be looked at on a periodic basis unless it breaches some sort of risk trigger and finds its way onto an exception report.

In part the frequency may be determined by systems capabilities but systems often continue to produce reports long after they cease to be of value which the recipient fails to understand. Change does not always occur until someone new takes over the job and challenges the situation.
Leading indicators

When considering reporting, emphasis should be placed on the provision of forward looking indicators, which anticipate possible deterioration in risk, rather than historical ones that provide information about the past. This is important as it gives management time to take action, preferably before others, particularly competitors, become aware of potential problems. If the first you know of a problem is when a loss has occurred, the probability of resolving the issue will be slim.

Anticipating risk events can be achieved by use of:

External leading indicators – these could include changes in exchange or interest rates, GDP growth rates, changes in regulations, inflation levels, etc;

Internal risk triggers – these would include financial ratios, production numbers, staff turnover, etc.

Whether internal or external measures are used, they must be capable of measurement fairly readily. A trigger value should be determined and action taken when the trigger is breached, otherwise they will be of little value. Financial institutions often operate on this basis by setting covenants on loan facilities which if breached allow them to either renegotiate terms, such as increasing margins, or call for full repayment.

Risk monitors

Examples of the leading indicator approach are the services provided by companies such as KMV and Riskmetrics.

Both these companies use sophisticated models to provide measures of risk that can be used to highlight deteriorating risk situations quickly.

The KMV approach, for example, uses share price movements working on the hypothesis that the stock market is able to absorb a wide range of information and factor it into the current share price. Research has shown that adverse share price movements lead problems emerging in a company by up to nine months.

Riskmetrics provides a score for the riskiness of deals making it easier to compare the risk associated with different types of investments.
Establishing leading indicators is of particular value for businesses operating in emerging markets, given their volatile nature. Unfortunately, the lack of good quality information in those very markets and their unpredictability undermines the value of any risk triggers that are put in place, including those developed by companies such as KMV. Remember, just because a risk model from which triggers are derived can explain past movements does not mean that it is guaranteed to do so in the future. In practice what is needed is a range of risk triggers which should be under constant review so both trigger values and the triggers themselves can be changed as needed.

**Disclosure**

Our ability to understand risk is sometimes frustrated by a lack of transparency. This can occur at two levels:

- **Internal** – business units or managers fail to inform their line managers or Head Offices of what they are doing;
- **External** – failure to disclose to shareholders, the public or regulators the true nature or level of risks a business is facing.

Clearly there is a need to balance providing too much and too little information and sometimes there are cultural barriers to conveying bad news, but when big bets are being taken, both of these types of disclosure failure can prevent senior management being aware of and taking appropriate action in time. The following cases illustrate this only too well.

**Big bets gone bad**

Businesses sometimes take significant risks. This is acceptable provided this is done knowingly and the status of the risks are measured and reported so that corrective action can be taken in case of need. Two of the more famous big bets gone bad are illustrated below.

*Barings* – Nick Leeson made apparent large returns for Barings by taking positions in stock index futures. What management in London did not know was that losses were actually being made but that these were being hidden, fraudulently, by Leeson. This lack of understanding of the
true position led to the downfall of Barings when an extreme (cata-
strophic in probability terms) event led to a huge one day adverse
movement in Tokyo stock prices.

Orange County – the Treasurer of Orange County, California, was
entrusted with management of a portfolio of USD 7.5 billion for various
public institutions. To increase the level of returns, however, he borrowed
an additional USD 12.5 billion and invested these in bonds. This produced
positive returns while borrowing costs were low but huge losses when
interest rates rose sharply. This investment strategy was essentially a huge
bet on interest rate differentials (market risk).

The difference with the Orange County case, however, was that the
position was disclosed. What was not clear was the level of risk being
taken as reports only showed the total position and not the “marked to
market” position. The true position, which would have shown growing
losses, was not provided as the assets were being held to maturity, rather
than traded, and government accounting standards did not require the
mark to market position to be disclosed. Better standards would have
made rising losses more obvious earlier.

Key lessons arising from these two cases include:

- lack of disclosure may be due to fraudulent activities being covered
  up, but can equally be due to inadequate reporting requirements;
- high returns are likely to be associated with high risks. There is a
  need to dig deeper where risks appear low but returns are high
  because of “too much success”;
- beware putting too much faith in one individual simply because he
  appears to have “the Midas touch”;
- follow the money. In both of the above cases, cash outflows were
  required to support the loss making positions. Senior management
  approved cash injections but they were provided without
  adequate enquiry;
- regulators need to understand risks better.

All of these problems are compounded in emerging markets by the lack
of disclosure rules, less stringent standards for reporting, and different
accounting standards applied. Even where rules do exist it is not uncom-
mon to find they are not strictly enforced. The problems that this can
create were evident in the Asian crisis when many companies got into dif-
ficulties and banks only subsequently found out how much they had
borrowed or the degree to which funds had been mis-used by way of
investment in non-core activities and/or speculative ventures, or how funds
had been lent to weaker associate companies without their knowledge.

**Push or pull?**

Most reporting can be classified as *push*. Data and/or information is
pushed out by a variety of systems and delivered to users often in paper
form as a pile of reports. Even if such reports are clear and concise two
problems remain:

- they are historic;
- questions arising from reviewing the reports cannot be readily
  answered.

One way to address these issues is to allow users to interrogate real time
systems which allows them to *pull* information as and when required.

When technology within organizations was based on mainframes the
ability to pull information off systems was limited. Current data could only
be obtained on limited areas of activity within fixed format screens. Today,
it is possible to make complicated enquiries across company wide systems
and have it delivered quickly and in a variety of forms, graphs, pie charts
or time-series data, for instance. Alternatively, aggregate data can be
viewed and any areas of interest can be drilled into e.g. group level infor-
mation can be drilled down to reveal regional, company or even customer
level data. Unfortunately, this capability is only available in a few organiza-
tions and rarely on a global real time basis.

**Risk measurement in emerging markets**

Let’s just think of our three scenarios and consider what measures of risk
would be appropriate, and what the particular issues operating in an
emerging market might throw up.
**Call centre**

The key risks in call centre operations are people, premises, communications and computer systems. The main risk is the inability to meet customer expectations. This would arise from operational failures and could lead to loss of reputation leading to customers moving their business to competitors.

As we have suggested, call centres are technology based and relatively new so performance management systems should be an integral part of their operations. Once risks are identified, data from these performance systems can be used to track and measure the level of risk e.g. on the number of available staff and their call handling capabilities, turnover rates, etc. This information will be available to management on screen real time or through a series of daily, weekly or monthly reports in standard formats.

To a large extent, the day-to-day operational risks faced in an emerging market environment will not be significantly different from those faced elsewhere, other than the greater reliance on international communication networks. Areas where there may be new risks could include dealing with language and culture issues, the availability of staff with requisite skills, and premises issues e.g. power availability. Not all these areas are as easy to measure e.g. the vulnerability of your operations to key staff being poached by competitors or new set ups. Equally, cultural problems often arise from unexpected quarters with little warning.

**Construction contract**

Construction contracts generally use project management methods to set down the required tasks, usually in great detail, and have well-established procedures for tracking the progress of the project against milestones. Measuring risks will fall out of this process in a fairly traditional manner – issue reporting, milestone shortfalls, etc. Management’s task is to keep the project on track and ensure that any problems do not result in project overruns. They also need to keep an eye on financial risk, particularly cashflow requirements.

In emerging markets, risk measurement problems can come about due to failures in the risk reporting mechanisms, especially when they rely on individuals e.g. problems may not get reported in cultures where people do not like to convey bad news or where there are language problems. Such problems are common because it is quite often the case that the main and various sub-contractors/consultants come from different countries and even within companies there are many nationalities on the payroll. Cultural problems can easily occur and they are difficult to spot or measure.
Manufacturer

Getting a manufacturing unit up and running can be a problem in emerging markets due to various hurdles. Once up and running, risks will exist at all stages of production through to selling, including sourcing of materials, keeping production going, storing goods produced, distribution and collection of sales proceeds. We have listed above many of the tools and techniques that can be used to measure the various risks through the process. Quality of data and the reporting processes are likely to be problematic in emerging markets, however, unless things have been computerized and there are adequate controls in place.

Areas of particular importance in emerging markets will be vulnerabilities to raw material availability, especially if far removed from the sources of supply, breakdowns in production due to technical, people or utility provider problems, corruption and fraud, security concerns, and movement in key financial factors such as interest and exchange rates and credit concerns. These risks can be measured using the approach set out above for looking at business risk. Management should assess the critical success factors and build appropriate forward looking key risk indicators. Some creativity may be needed given the range of possible problem areas in these markets.

Possible developments

Enhancements in technology and risk metrics has meant there have been significant developments in which risks can be measured, how they can be analyzed, and how and when risk information can be delivered and to whom. Significant investment in systems has meant that real time information is more readily available while advances such as the use of neural networks mean some systems can monitor performance and manage increases in risk without manual intervention. These remain the exception, but they will become more common in years to come.

It is clear that the following factors are significantly increasing our power to collect, analyze and deliver risk information to risk managers:

- rapid increases in computer power combined with more user friendly means of making data enquiries;
- significantly lower computing and communications costs;
Such enhancements are, however, only enablers as identification and management of risk still require the application of judgement and experience. Going forward there will be a need to ensure that there is continuing development of risk models and theories in order that technical developments can be used to develop measures of risk which extend across a wider range of risks and can help provide a common language for measuring risks across risk categories. This is a subject that will be developed more in Chapter 8.

Conclusion

Our ability to manage risk effectively is dependent firstly on being able to identify potential risks, and secondly being able to measure those risks. This is easier said than done. For some areas, credit and market risk for example, there are well developed industry standard tools and techniques but as we move across the spectrum of risk, the degree of difficulty increases and, as yet, there is no industry standard for measuring risks across risk categories.

We have explained some of the common tools in use but to a large extent we will need to rely on simple measures, such as aggregate exposures and trend analyses, in emerging markets because of the quality of data available. Plus, there is less confidence in the predictive value of models in volatile environments. Blindly following an inappropriate model is as risky as having no model at all.

Going forward there is a need to continue to develop theories and models but much can be done to improve the quality of risk measurements simply by ensuring that things such as data standards are clearly defined, and that systems and incentives are in place to improve the quality of data flowing through to decision makers. As we rely more and more on data for measuring risks, and technology enables us to look into risk areas from afar, this will become more and more important.
Summary

The key messages from this chapter are:

- Our ability to measure risk varies with the risk types we are dealing with.
- It is difficult to measure interrelated risks.
- There are a variety of data problems which need to be addressed including setting data standards and ensuring they are enforced.
- Data on its own is of little value, it needs to be turned into useful information.
- Risk models are a useful way to turn data into information but care is needed that users understand the limitations of risk models.
- There are many ways in which risks can be reported. It is a matter of judgement on which is the most appropriate in any given situation.
- Leading indicators are preferable to backward looking risk measures;
- In emerging markets, data problems are significantly greater than in the developed world both in terms of quantity and quality.

References


"To view risk management only as the process of reducing risk is to miss potentially significant efficiency enhancement and new business and product development opportunities"

CHRISTOPHER CULP

Introduction

Successful businesses survive and grow by taking risks and continually adapting and responding to the changing environment in which they operate. To do this it is necessary to have:

- a coherent strategy
- an effective risk management framework
- robust but flexible implementation.

The key to success is understanding the risks the organization faces from the external environment and the capability of its internal resources to deal with those risks. The way this is achieved is through a planning process that sets the strategy for the organization. That strategy is then executed through a series of business level plans supported by short term tactical plans. This relationship is illustrated in Fig 4.1.
Determination of strategy, however, does not occur in isolation as due consideration of risk issues is required. One way of looking at this is to think of it as a balancing act as shown in Fig 4.2. Taking of business risks (see Fig 2.2) creates risks that need to be balanced by ensuring there are adequate resources allocated to managing those risks. The balancing act is a continuous one which requires the above mentioned key requirements to be addressed, namely:

- A coherent strategy – this is set in relation to the external environment or market opportunities and will impact on the left side. The riskier the strategy, the greater the downward pressure there will be.
- An effective risk management framework – the riskier the strategy the more resources will be needed to counterbalance it on the right side.
- Robust but flexible implementation – this requires continual readjustment to ensure that risk is kept within acceptable levels, adjusting the strategy, or applying more resources to manage the risks.

Flexibility requires feedback loops to be built into the process and a willingness by management to react when the evidence indicates the need for change. In this regard we must be aware that risks are sometimes caused by being too successful rather than not being successful at all e.g. internet banks being inundated with new application forms when they have made attractive offers to bring in new customers. Figure 4.3 shows how we can expand the
strategy and business plan execution process shown in Fig 4.1 to include feedback loops by including the stages of monitoring outcomes, reviewing results and deciding what to do. Depending on the importance of the outcome we might want to revisit tactical plans, longer term plans or, in the worst case, the strategy itself. What has happened in recent years is that this cycle has become compressed due to greater uncertainty and volatility, and strategies are often changed more frequently with one to three years becoming more the norm.

![Diagram of strategy and risk execution process]

**Fig 4.3 Review process and feedback loops**

The next three sections will look at strategy and risk, the risk management framework and implementation in turn to explore these issues in more detail.

**Strategy and risk**

Setting strategy is a key element in managing risk because it sets the direction for the business as a whole. A clear strategy, appropriate to the current and future competitive position of a business, which is properly executed should ensure that the risks assumed are manageable. Adequate rewards for taking those risks will be earned while any downsides are capable of being absorbed. In contrast, operating without a strategy or having an inappropriate one can spell disaster. A commonly quoted maxim is “if you do not know where you are going then any path will do”.

Where clarity exists, resources do not get wasted on pursuing opportunities which do not fit with the business strategy. A macro level example
would be not acquiring a company even where the price was considered attractive because of a lack of fit with the current business plan. At a micro level an example would be turning away a specific piece of business for the same reasons e.g. the customer was too far away or the order too complex. Prerequisites for this to occur are knowing where you are today and setting clear goals which are well communicated.

While it may sound strange that we would not know where we are today, we only need to think of the issues on data availability and quality which were covered in the previous chapter and those on accounting risk in Chapter 2 to understand how this could be a problem. Simple things such as knowing the size of the market you are operating in and your share of that market are not always easy to come by. In emerging markets this is even more difficult.

Setting goals is a little easier but will clearly only be meaningful if it is possible to determine when they are reached. How aggressive those goals are will have a direct bearing on the risk associated with the strategy that a business adopts. Goals may be simple financial targets or a broader range of measures – some organizations, for example, use the balanced scorecard approach that ensures that financial achievements are not made at the expense of other areas of corporate responsibility such as staff and customers. Measurable goals for a business might include one or more of the following:

- achieving a target level of profits in absolute terms;
- achieving a target or minimum percentage return on equity;
- to be the market leader;
- to see an increase in share price greater than the market or competitors;
- to see a steady growth in profits;
- to be recognized as a good employer, innovative organization, good citizen, etc;
- to have the highest level of customer satisfaction in the industry.

The further the goals are from the current position and the shorter the time-frame set to attain them, the more aggressive the strategy must be to ensure they are achieved. A pertinent issue here is which markets should a business target as this has a significant impact on risk.
Companies that have been in business for some time have found that they have been able to grow within their domestic market through organic growth and/or by acquiring competitors. A point is often reached where their share of the domestic market reaches a level which it is difficult to increase because of restraints on monopolies or markets reaching maturity. The fast food market in the US is a good example.

For management used to a growing business, and rising profits year on year, saturation in the domestic market leaves them with two options – enter new businesses or seek new markets. These options are illustrated in Fig 4.4 which shows Ansoff’s Matrix.

![Ansoff’s Matrix](image)

The least risky strategy is generally to stay in the area you know best (top left quadrant – market penetration). To take existing products to new markets (bottom left – market development) or introduce new products to new markets (top right – product development) can increase risk, while moving from top left to bottom right, diversification, in one move is considered very risky. Which is the right strategy for a particular company will of course depend on the nature of their business and the markets in which they operate, the state of competition and the degree of volatility associated with these factors. (See Ansoff’s *Corporate Strategy* for a detailed explanation.)

McDonald’s aggressive expansion into regional and then global markets can be seen as an appropriate, and the least risk strategy, when faced with increased competition and a stagnating home market. Initially
that expansion occurred in developed markets but in time they too became saturated. In due course, McDonald’s expanded into various emerging markets starting with the most attractive (Hong Kong, Singapore) but even they are becoming mature and they are moving further afield each year. To maintain growth they are now having to look to other food products besides burgers.

In contrast, tobacco companies which tried to diversify away from cigarette production into food and drink should not have been surprised that they were not very successful. Many are now divesting themselves of the businesses they acquired during the past decade or so, often at great cost.

The above example illustrates how strategy and risk can be linked together. This is not the place, however, to discuss in detail the process by which business strategies are documented and evaluated but it is worth considering factors which influence the process by which the strategy to be adopted is chosen. This is important because it is clear that the strategy adopted will have a strong bearing on the overall level of risk that an organization will face.

**Risk appetite**

The first issue to consider is the risk appetite of the senior management team, usually the board. By risk appetite we mean the level of risk that the management team is prepared to accept. Taking on a contract in an emerging market is a good example where risk appetite can be tested. It is clear that such contracts are riskier than undertaking contracts in known markets with known sub-contractors and a sound judicial system to deal with disputes, but if business is not good or margins are under threat it is only natural to look overseas. Risk appetite defines how big a bet management will take on one contract or country. If a company does USD 100 million of business and takes on a contract of USD 10 million in an emerging market there is room to fail and not hurt the company. If total business were only USD 20 million taking on a contract of this size would be much more life threatening if things went wrong. Those willing to take that bet would be considered aggressive risk takers.
**Constraints on risk taking**

In some circumstances, the level of risk that an organization is prepared to take will not be limited simply by the risk appetite of managers but the risk appetite of other stakeholders. The most powerful stakeholders include:

- regulators – who can prohibit certain activities or proposals;
- trade unions – who can threaten action if they feel their members are threatened;
- shareholders – who can call for the removal of the chairman/CEO or board members;
- the public – who can demonstrate against the company and/or generate adverse publicity.

Other stakeholders who might seek to influence management but may be in a weaker position are:

- suppliers and customers – they would only have influence where they supply or buy a significant proportion of production/raw materials;
- staff – unless unionized they are unlikely to be able to influence strategy;
- external auditors – they can annotate accounts or resign their services but it is usually possible to find an alternate supplier of services who may be more “compliant”.

Fewer problems are likely to arise from stakeholders where organizations use a broader based approach to setting targets through using techniques such as the “balanced scorecard”.

**Independent risk function**

In addition to considering the stakeholders, we also need to look at the risk management function and see how well identification and measurement of the risks associated with various strategic options has been carried out. All managers are expected to manage risk but it is important that there is an independent review to ensure the analysis is complete. It is essential, therefore, that risk managers are brought into the strategy review process early on and given adequate time to assess and give their input on proposals.
Who decides?

The final point to consider is who decides on the strategy? The worst possible situation is where all decisions are made by an autocrat who listens to advice but then ignores it, or simply does not listen. This is not uncommon in owner/entrepreneur type organizations or in family run businesses, even those that are quite large in size or are public companies. This problem is quite prevalent in emerging markets where the owner/founder, or close family, run large businesses in a semi-dictatorial manner which stifles debate on the risks associated with the “chosen” strategy. This creates key man risks in such situations as well as frustrating senior managers who are not allowed to make decisions that they are very capable of doing.

The preferred option is to have a full and frank analysis on risk issues which should be carefully debated before agreeing the strategy, having given due consideration to the return side of the equation as well as the risks. In making the final decision there is, for reasons we have explained in Chapter 1, likely to be some disagreement over the nature and size of the risks as well as different attitudes to risk depending on each individual’s past experience, position within the organization, area of responsibility, etc.

Hopefully the final decision is a rational one which produces a strategy appropriate to the markets in which a company operates and its resources, but past disasters have shown that this is often not the case. Strategic decisions, such as those related to construction contracts in new markets, have often been made which “bet the company” on expectations being achieved with no fall back position if they do not. Many acquisitions, particularly in unrelated industries, or expansions into new, especially emerging, markets have failed for this reason. In emerging markets many businesses have been caught out after they bought into or set up a bank because they wanted a house bank for their group. Managing a bank is very different from managing a manufacturing or trading business, as most found out to their cost.

Whatever the strategy, it is important that it is supported by an appropriate risk management framework. Figure 4.5 shows how these are related. This is a slightly different way to look at the issues shown in Fig 4.3. To achieve business objectives, a strategy is required but it needs to be executed. Execution requires business decisions to be made. Once these decisions are made outcomes will result. Those outcomes may be positive or negative but either way, the information gained will be fed back and used in the next set of decisions. All of this activity will take place within the risk management framework of the organization. Let us consider this in more detail.
The term risk management framework means:

the structure within which the management of risk is effected within an organization.

Elements of the framework include the:

- degree to which risk management is centralized or decentralized
- policies set for the management of risk
- processes for making decisions
- way in which authority is delegated and use of it monitored
- technology used to record and analyze data (including risk models)
- reporting mechanisms
- committee or other processes used for reviewing risk
- audit process.

Let us consider the first point in more detail.

**Centralization versus decentralization**
The most traditional form of risk management framework has been one based on “command and control” principles. The features of a command and control structure are:

- a strong central body (head office);
- emphasis on detailed policies, procedures and rules set at the centre;
• branches and subsidiaries required to follow the rules;
• little or no discretion given to local management (most decisions made at the centre);
• communication largely top to bottom, reporting bottom to top.

Such a structure was put in place during an era when businesses were relatively simple, risks were fairly predictable, communications were not as easy as today and management skills were not strongly developed. Today’s environment is, however, much more complex and changeable so the command and control approach is no longer the preferred way for many organizations. “Head Office knows best” no longer holds true. It has also been recognized that this approach is highly bureaucratic, giving the head office functions the reputation as “business prevention departments”, instead of ones supporting and encouraging business development. With risks occurring everywhere, management of risk needs a more balanced approach.

The centralized approach has not died, however, and it is still in evidence in a number of areas e.g. high risk environments such as complex industrial plants and nuclear power stations, or in highly regulated industries such as finance. In addition it is still common for parent companies to control investment decisions centrally, and have detailed rules governing logos, stationery, etc, in order to ensure a consistent image and to protect the company brand. McDonald’s, for example, have strict requirements that all franchises and branches must follow and standards that they must maintain.

The alternative to command and control is to operate on a more decentralized basis, the features of which are

• smaller central function with a higher level and more strategic role;
• high level policies, procedures and rules set at the centre;
• discretion given to local units to put in place their own policies and rules and manage day to day decisions;
• management encouraged to be flexible but to report upwards issues of concern;
• increased use of systems to measure and monitor risk;
• regular bottom up and top down communication;
• emphasis on exception reporting.
This approach is necessary in order that a business can quickly react to new business opportunities and changing risks without being hampered by bureaucratic processes. Technology allows the centre to decentralize authority and responsibility while, at the same time, having more information available to monitor how that authority has been used and quickly identify potential risk concentrations or issues.

In this model, the centre adopts a high level role through setting the principles by which a business’s risks are managed and then monitoring performance. Its role is also to ensure that there is an adequate level of risk awareness throughout the organization. The centre thus adopts a more consultancy/educational type stance helping the business to identify, measure and then manage risks more effectively.

Some of the most well publicized failures in recent times came about because businesses failed to see the change in the nature of risks and did not adapt to them. By having a centralized risk function with a high level brief management should be able to help the business see these changes coming and thus prevent the mistakes of others being repeated. In some emerging markets, this type of change has come very quickly and created problems of a different kind.

A better world?

Countries which operated under the most rigid of command and control structures were those with communist regimes – Russia and its satellite Eastern European countries, for example.

In the late eighties and early nineties, communism crumbled and the majority of these states moved, almost overnight, from a structure where everything was dictated from the centre, to a free market economy.

Having been used to being told what to produce, who to sell to and on what terms, it is not surprising that problems arose for managers and workers who suddenly had to think about customer service, product quality, competition and so on.

There were hard times, which still continue in some areas, as these economies and managers/workers had to change from a command and control economy to one where they had to make their own decisions and make a profit to survive. Many businesses closed, many others required foreign investment/expertise to continue in operation.
This example is drawn from a fairly dramatic time in the history of these economies but within companies the transition from central control to decentralization does not always operate smoothly and can increase the level of risk. In some emerging markets, a strong command and control environment still exists though free market economics are becoming a stronger influence, China being a leading example of the old and the new co-existing. To some extent, the problems that occurred in the Asian crisis were caused by the economies opening up when they did not have the infrastructure or management skills to deal with a new set of risks in a more volatile environment, much as the former East European communist countries struggled in the early nineties.

**What type of risk management framework?**

As we have indicated above, both centralized and decentralized approaches will be found in all organizations. What is best for each organization will be influenced by many factors. Some of the factors which need to be considered are set out in Table 4.1. A number will be familiar to you from the discussion of business risk in Chapter 2.

<table>
<thead>
<tr>
<th>Factors influencing risk management requirement</th>
<th>Dimensions to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy</td>
<td>aggressive or conservative.</td>
</tr>
<tr>
<td>Risk appetite of owners/managers</td>
<td>risk taking or risk averse.</td>
</tr>
<tr>
<td>Industry</td>
<td>sunrise or sunset industry; primary, manufacturing, service sector.</td>
</tr>
<tr>
<td>Geographical coverage</td>
<td>local, national, regional or global.</td>
</tr>
<tr>
<td>Critical success factors</td>
<td>is the company critically dependent on one or two factors which require close management?</td>
</tr>
<tr>
<td>Volatility</td>
<td>is the environment likely to change significantly or unpredictability?</td>
</tr>
</tbody>
</table>
If we look at how risk frameworks have developed in practice, there is quite a wide range with, at one extreme, the one man business and, at the other, global multi-billion dollar organizations. Industries at the leading edge in risk management are the insurance and finance industries.

The finance industry, for example, has pushed the boundaries of risk management in recent years because of changes in the nature of the risks it faces and the desire for greater real time information on them. Regulators have also become more intrusive because a disruption in payment systems or a bank failure could have severe implications for the economy as a whole. The result has been heavy investment in risk

<table>
<thead>
<tr>
<th>Position in industry</th>
<th>monopoly, few or limited number of players, or free market with many players and no barriers to entry.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory environment</td>
<td>is area of operations highly controlled by legislation and/or regulatory bodies? Are regulators intrusive or hands off? Is deregulation occurring or the level of regulation increasing?</td>
</tr>
<tr>
<td>Management style</td>
<td>centralized or decentralized.</td>
</tr>
<tr>
<td>Resources</td>
<td>adequate or inadequate people and technology resources. financial position – adequate funds available, highly or lowly geared.</td>
</tr>
<tr>
<td>Status/ownership</td>
<td>public or privately owned. Sole proprietor, partnership, limited company, unincorporated society.</td>
</tr>
<tr>
<td>Organizational culture</td>
<td>is the culture strong or weak?</td>
</tr>
<tr>
<td>Nature of risks faced</td>
<td>are they simple and predictable or complex/unpredictable? is the size of risks manageable or is catastrophic risk a cause for concern?</td>
</tr>
</tbody>
</table>
measurement systems, and the creation of co-ordinated risk units that look at not only credit, but also market and operational risks (the so-called holistic approach to risk). In emerging markets these developments have not occurred at the same pace. Many locally owned and managed banks and finance companies, for instance, ran into problems or collapsed completely in the Asian crisis because they lacked adequately resourced independent risk management units. Risk rating systems were rudimentary, sectoral concentrations were high, and lending to related parties was common. Years of high growth enabled the cracks to be papered over but they came through when the economy turned down. Rescuing these banks has been a huge drain on already weakened resources for some emerging market governments. Unfortunately the process has not been completed and additional costs will be incurred. Consolidation and better regulation is now being seen in the industry but there is a long way to go.

Outside the finance industry, developments in risk management have not been so far reaching but some industries such as utilities and the oil and gas industry have moved forward especially in areas such as operational risk. Most owner-entrepreneurs, in contrast, continue to rely on age-old methods such as gut feeling and experience. Many continue to have little or no formal risk management structure. Indeed, the rule in these organizations is usually “refer to the boss” and when he is not there decisions are not made. In emerging markets this is not an uncommon approach even where the business has grown quite large.

Table 4.2 summarizes the types of the risk management frameworks likely to be found in a variety of organizations, taking into account the size and the nature of risks that they face.

<table>
<thead>
<tr>
<th>Type of organization</th>
<th>Risk management framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global bank</td>
<td>holistic approach to risk. Central function sets high level policy and procedures and monitors their execution by the businesses who take day to day responsibility for managing risk. Real time measurement systems and risk models used where possible. Regular review of risks and reporting to the centre and board members.</td>
</tr>
</tbody>
</table>
Whatever type of organization we are looking at and whatever the nature of its risk management framework there are certain basic principles which need to be followed to minimize risk. These include:

- full assessment of risk will be undertaken prior to making decisions;
- all risk decisions will be documented;
- authority will only be delegated to staff with the appropriate levels of skill and experience and the person delegating authority remains accountable for its use;
- persons may not propose and authorize transactions (dual control or four eyes principle);
- risk decisions will be reviewed wherever circumstances change;
- carry out independent checks, do not take things on trust.

**Table 4.2 continued**

<table>
<thead>
<tr>
<th>Multinational manufacturer</th>
<th>centralized control of financial risks and investment decisions. Production/sales management decentralized but will be required to operate within an overall broad policy and authority framework.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regional service industry</td>
<td>largely decentralized with small centre controlling finance and investment. Focus on sales/marketing, customer service issues and reputational risk. Technology risks issues may be important in some sectors e.g. Internet operations.</td>
</tr>
<tr>
<td>National non-profit organization</td>
<td>unlikely to be a risk department with any issues being managed through finance function or the person in charge of daily operations. Few simple rules only.</td>
</tr>
<tr>
<td>Owner/entrepreneur</td>
<td>no risk function. Decisions made as and when required but not always in a consistent manner. Few if any written rules.</td>
</tr>
</tbody>
</table>
Failure to abide by these principles is evident in many of the well publicized corporate failures. In Barings, Nick Lesson had control over both the front and the back office (lack of segregation) which allowed him to hide his losses without detection for so long. Many cases of fraud occur because people fail to question instructions given to them. Many credit losses occur because there is pressure to do the deal and the relationship manager fails to challenge the customer on basic things such as sales forecasts, assumptions underlying business plans, etc. These are all issues we need to consider in the next section.

Key elements of the risk framework

It is clear from the previous section that the size and nature of the risk framework that is established for a business will vary quite considerably but there will be a number of elements that are common to them all. These include:

- ensuring there are adequate checks and balances
- defining roles and responsibilities
- setting delegated authority levels
- establishing limits or thresholds
- putting in place appropriate policies
- documenting procedures
- defining risk models
- determining reporting requirements
- monitoring changes in risk.

We will address each of these in turn.

Checks and balances

It is necessary to have in place adequate checks and balances to ensure the right things are being done and that the rules are being followed. The more an organization is driven by short term results the more important these checks and balances are.

Organizationally, the main way in which checks and balances are addressed are through having a structure along the lines of:

*Business management* – responsible for business development, setting strategy and managing day to day risk issues;
Independent risk function – determines the rules of the game within which
the business must manage risk and will monitor the nature of the risks
facing the organization and how well they are being managed;

Internal audit – periodic in-depth review of how well the rules of the game
are being applied in practice;

External review – this will include the regular review by external auditors in
relation to the production of audited financial statements but may well
include inspection by other regulatory bodies e.g. central bank inspections,
health and safety reviews, etc.

Business managers are responsible for managing risk day to day but the risk
function sets the framework within which they operate. The risk function,
however, works best when it operates close to the business rather than sitting
in an ivory tower at a distance. In line with the move away from
command and control structures, the trend has been for the head office
function to shrink in size and for risk personnel to be dispersed to the busi-
ness units. This is only effective, however, if the risk personnel report solely
to the central risk function to retain independence. This is necessary
because one of the roles of the risk function is to act as a whistle blower if
undue risks are being taken or rules are being ignored or breached.

Internal and external audits are required to provide comfort to the risk
function that the rules are being followed. In addition, comfort will be pro-
vided to the board, as well as external shareholders, regulators, etc, that
both the business and the risk function are operating effectively but there
is always a concern that the risk function can have its independence com-
promised by “getting too close to the business”. In an ideal world,
business managers would have the same view of risks and take action to
address them as risk managers might. Equally you would want risk man-
gers to understand the business point of view and act accordingly to
support business development. Getting the balance right is a delicate task,
as is ensuring that a long term view of risk is taken which is not forsaken
to gain short term bonuses.

Roles and responsibilities
In addition to having adequate checks and balances, it is necessary to
ensure that all parties in an organization are clear on their roles and
responsibilities from the board down to the lowest management level.
The need for this is often brought home when an investigation takes place into an unexpected or adverse event. In such circumstances, it is not uncommon to find that everyone thought someone else was responsible for identifying and managing risks. The result being that no one did anything. Obviously it is better to have clarity before, rather than after, the event.

At the highest level the board, or equivalent, is ultimately responsible for managing risks across an organization but day-to-day responsibility rests with line management and not, as commonly thought, the central risk management function. In this respect, calling the central unit risk management actually does a disservice to the organization as it suggests its role is more proactive than it is. The central risk function should have a monitoring and control role, not a management role. If it gets involved in management then it is likely that its independence will get compromised. The need for independence, however, is not limited to risk and business but occurs within the business function also. Consider the following example.

Customer service

Maintaining a good level of customer service is important for companies operating in the service sector such as restaurants, shops, internet service providers, call centres, etc.

One way in which the level of customer service is monitored is through having a service quality unit to measure and report on a mix of objective and subjective measures such as time taken to process orders, speed in answering calls, accuracy of information provided, friendliness and so on.

The service quality unit’s responsibility is to report on how well the unit under review is doing. It is an independent unit but part of the business. Unit management is then responsible for taking action to address any areas of concern. If they do not, they run the risk of customer attrition.

In essence, the risk function is like the service quality unit. It monitors how well the business is doing against agreed parameters but it is the responsibility of the business to take action.

One area where clear definition of roles and responsibilities often causes problems is in joint ventures. This is a quite common issue in emerging markets due to the need for local partners in many countries.
Delegated authorities levels

Another important element in the overall risk management framework is putting in place a clear authority structure. It is like roles and responsibilities, gaps usually come to light when something goes wrong e.g. someone thought that they had authority to do something but did not. Unfortunately, while it sounds simple it can be difficult in practice, particularly for areas it is not easy to attach objective values to. For example, it is easy to define authorities which involve monetary values – granting credit, approving expenditures, project authorizations, etc, but for something which is intangible, like agreeing the theme for an advertising campaign, it is less clear cut.

Trying to address this issue can be problematic. The more areas you define and set down authorities in relation to, the more you are likely to find things which do not fit. It is not surprising, therefore, that in entrepreneurial organizations the rule is one of upward delegation – refer everything to the owner. In larger organizations, for owner read unit manager, in an emerging market, read country manager.

Clarity, but some flexibility, is required. This must cover what to do if decisions are required which exceed laid down authorities. What do you do if the person you need to contact cannot be found? Do you exceed your authority and take responsibility or do you simply say no? Which is the bigger risk for the organization? Which is the bigger risk for you personally? It is an operational dilemma that occurs all too frequently. On a construction contract for instance decisions may need to be made quickly to avoid disaster. If people wait or dither because they “do not have authority” then the overall cost could be greater than actually making a decision. In a strong risk culture, doing the right thing is more important than blindly following laid down authorities, within reason of course.

An area where organizations differ is on giving authority to individuals versus committees. The latter slows down the process and also makes accountability less personal. The preference is for individual authority but committees are not uncommon in government, non-profit organizations, or similar. In profit seeking organizations, committees may be the appropriate place for significant decisions to be made e.g. setting strategy.

Setting limits

As we have said earlier, many businesses have failed due to undue concentrations of risk, and diversification is one of the most important rules of risk management. Although as Bernstein said, diversification is not a guarantee against loss, only against losing everything at once, which is well illustrated by the following:
Key issues with regard to limits are:

**Limit types** - limits can come in many shapes and sizes. They can be set to control portfolio concentrations or the maximum size of individual exposures, limits for safe operation of equipment, maximum number of hours that lorry drivers can operate continuously, maximum authorities for approving expenditures and so on.

**Determining appropriate levels** – setting limits on risk is part art, part science. It is sometimes a contentious subject as it involves judgement, even where it is possible to put reasonably accurate numbers on the risks involved. Set limits too low and many decisions have to get referred up, set them too high and control can be lost if poor decisions are made.

Limit setting also has two dimensions:

- what is the absolute level of a limit?
- what level of authority should be given to any one individual within which to make decisions?

The first concerns safety limits for the organization and should be set by considering the probability and size of impact, and relating that to affordability. The higher the possible impact, the lower the limit should be set, even if probability is low.
The second relates to the power given to individuals to make decisions. In a traditional command and control environment, limited authority is given to people outside the centre. The trend now is to move away from this and increase the level of discretion given to business managers. Higher authority means greater responsibility and should only be given where there is confidence that it will be used carefully. This is of particular importance in emerging markets given that well qualified managers are often hard to come by and the levels of risk are usually greater. Individual discretion needs to be related to skill levels, experience and proven track record but what is common these days is to see more authority given at a younger age. This has risks attached to it which need to be carefully monitored.

**Structuring limits** – one way that risk can be managed is to structure limits according to the nature of the risk. Launching new projects or products is one such area where there may be stricter controls. New products may need to go through a product approval process including pilot testing. New investment may require financial targets be hit e.g. minimum return on capital. In banking, taking on new credit customers is generally higher risk than extending increased credit to existing clients, so it is not uncommon for new loans to be referred to higher authority.

**Excesses** – approaching a limit is like a warning sign. It says BEWARE but it does not necessarily stop you. Most limits will have some level of tolerance, just as you will not get a speeding fine for going one kilometre an hour over the speed limit. While accidental excesses can occur, prior approval is the preferred option for which justification and approval at a higher level will be necessary. There will, however, be some cases where limits are absolute and cannot be breached e.g. those set by regulators. If excesses occur, plans must be made to ensure that they are cleared within an agreed time-frame.

**Monitoring** – it is important that the use of limits is closely monitored to identify as early as possible potential problems. This is important as a disproportionate number of problems/losses arise due to the failure to stick to agreed limits. The usual problem is that there is often a financial cost to saying no and there may also be reputational costs. If a customer has reached his credit limit, for instance, a salesperson is more than likely to push for an increase in the limit to secure a sale, as saying no will probably have an impact on revenues and may damage the relationship with their customer. A similar story is often heard when a particularly large order is received and it is a brave manager who says no, as greed so often corrupts rational behaviour.
Discipline - the final issue on limits to consider is discipline. It is no use in having limits which are exceeded and no action taken against those who abuse the trust they have been given. It is important, therefore, that remedial action is taken both quickly and decisively when transgressions occur. This needs to happen whether or not loss occurred as a result. If no action is taken because there is no loss this sends the wrong signals and encourages others to do the same or the same person to take bigger risks next time, both of which could result in losses. The other aspect is that punishments are of little value if there is no publicity. Care is needed here due to labour laws, union rules, etc., but a degree of transparency is required to ensure there is an appropriate message sent. This is all part of the checks and balances process described above, and also has a strong influence on risk culture which is covered below.

Policies

Policies are statements which define expectations, set down what the organization will or will not do, or what they permit. Policy statements include:

- we will not finance armaments;
- all staff are required to take a minimum of two weeks continuous leave at least once a year;
- all personnel must wear safety equipment on site;
- we will not provide financial guarantees for subsidiary companies;
- all staff must comply with all health and safety requirements;
- we do not pay bribes.

For policies to work well it is necessary that they are:

- clearly written with little room for misinterpretation;
- well communicated so everyone knows what they are;
- adequately policed.

In the command and control environment, policies are often enshrined in a thick and detailed manual. Today the pace of change is so fast that it is not possible to put in place policies to cover all eventualities. Consider the policy requirements arising from staff having Internet access.
These policies are fairly commonplace today but have only been put in place in the past few years. There are undoubtedly new developments for which policies are required but are not yet in place. It is always a game of catch up. The flip side is that there are likely to be old policies that are no longer appropriate but have not yet been cancelled. The law is in the same situation and is slow to catch up in both developed and emerging markets, although in many cases emerging markets are far behind.

Given the fast pace of change today it is better to have fewer high level policies and let the local managers “fill in the details” at country level. Like giving higher authorities though, this can only happen where you have well qualified management who can be relied on.

**Procedures**

Procedures tend to go hand in hand with policies. Policy relates to “the what” while procedures detail “the how”. In practice the two often become intertwined and many people confuse procedures with policy and vice versa. This is largely because it is difficult to set down procedures without a policy framework, so they tend to get written and distributed together.

Like policy, the essence of good procedures is clarity. The reader should know with certainty what to do when. At a basic level, procedures may
cover how production lines should be operated, how to repair or maintain machinery, how to process sales applications, what to do in an emergency, how to process a credit card application form, etc. They may be detailed step-by-step instructions or broader requirements that highlight dos and don’ts. Today they are likely to include flow charts and diagrams as well as text and may well be available on-line with interactive features.

Well documented procedures will:

- provide consistency;
- give audit standards against which to check compliance;
- provide a reference point;
- ensure that new entrants are trained in the right way to do things;
- provide a benchmark to check against best practice.

The problem with procedures is that the pace of change is such that it is difficult to keep them up to date because things move so fast. Technology helps here, through the ability to keep records centrally and distribute electronically, but there is still the need for someone to write them up. Many procedures become out of date quite quickly. Another problem is that writing things up in the centre does not provide the flexibility for the manager in a distant operation. This is of particular relevance in emerging markets where head office procedures may not work well due to local differences in requirements, culture, etc. Language is another problem. Interpretation between people speaking the same native language can be as much a problem as between those where native languages differ. How much time is spent trying to understand “head office speak”?

Models

We have already described the need to measure risks as a precondition for effective risk management. Part of the risk framework involves the building and maintenance of risk models, a task that is best performed in the centre because of the need for specialist skills and to ensure independence. Models are all very well but they must be treated with caution, as explained in the section on Model risk in Chapter 3 details of which need not be repeated here other than to reiterate the point that an issue for emerging markets is that models are usually developed using data gathered in well developed business environments and applying them outside of those areas may lead to incorrect conclusions.
For manufacturing businesses, controls that were developed in temperate climates may not work in high temperature environments.

Reporting
Business and risk managers need information to manage and monitor the risks facing the organization and developments therein. Issues on reporting have been covered in detail in Chapter 3 and will not be repeated. Suffice it to say the quality and quantity of information must be sufficient to ensure that everyone is well informed at the right time to make the right decisions for the organization. This can vary from real time information to a once a month report when needed.

Monitoring requirements
As we have suggested earlier, risk is like a bar of soap – as soon as you think you have got hold of it, it suddenly slips from your grasp and goes in an unexpected direction. This means that processes need to be in place to monitor how risk is changing over and above simple reporting of the size of risk exposures, or risk concentrations.

Some of the ways this can be done are:

Use of leading indicators – there is more chance of managing risk if it is anticipated well in advance, the more so if you can do this before competitors find out e.g. it is easier to exit from a deteriorating credit situation.
if there are still willing lenders, or to shut down a production plant if warning signals are evident well before critical thresholds are reached. Good or bad weather can be lead indicators for above or below average harvest, and hence low or high commodity prices.

**Setting risk triggers** – there are usually a few critical elements which impact on the viability of a company. Understanding what these are is the first step in managing risk, the second is to find appropriate measures of risk relevant to those factors, and the last is putting in place trigger values. Determining what the risk triggers are can be done through defining the critical success factors for the business. Values must be based on potential impact and past experience. Interest, exchange rates, commodity prices, tariff levels, etc can all be important risk triggers.

**Stress testing** – computing capabilities are now such that it is easy to check the downside of extreme values on an individual risk or a portfolio of risks. In engineering terms, situations are stressed to breaking point e.g. at what point does a nuclear plant become unstable? Knowing stress points can help determine leading indicators and risk triggers.

**Scenario planning** – stress testing simply takes where we are today and changes the values of variables. Scenario planning considers alternate possible futures and tries to put some values on their outcomes – what if oil prices went to USD 100 per barrel, what if an engine was invented which did not require oil, what if the sea level rose by three feet in the next ten years, and so on. This technique is often used for long term planning. It is particularly well developed in the oil industry, for example. It is well explained by Peter Schwartz in his book *The Art of the Long View*. Given the types of developments that have occurred in recent years, many of which were unforeseen, the importance of scenario planning is going to increase. This is likely to be even more significant in emerging markets, given their vulnerability to external shocks.

**Summary**

Building a sound risk framework requires all of the above to be addressed to define clearly and in an appropriate manner the way in which risk should be managed within an organization. This, of course, is not sufficient.
Implementation

For risk management to work effectively within an organization, there needs to be:

- a comprehensive package of tools and techniques for managing risk (a toolkit);
- strong risk culture.

We will take these in turn.

**Tools and techniques for managing risk**

There are a variety of ways in which risk can be managed and several have already been mentioned. The various techniques will usually address one or more of the following:

- what deals should we do – the process for acceptance of new business within an agreed strategy;
- on what terms should we do business – what mitigants can we take to minimize risks;
- how shall we control risk – controls and processes for handling risks which have been accepted;
- how should we monitor business – procedures and reporting mechanisms for monitoring risk levels;
- trading risk – selling or transferring risk to others or buying risks to balance a portfolio.

![Fig 4.6 The risk loop](image-url)
These will all operate within the agreed strategy and within the risk management framework established for the organization. Diagrammatically, this can be represented as the risk loop introduced in Chapter 1, repeated as Fig 4.6.

For each risk decision the process involves collecting information, processing it, assessing it and making a decision. That decision will be one of:

- accept it – take on the risk as it is;
- mitigate it – take the risk but seek to mitigate it;
- decline it – refuse to accept the risk.

If the organizational strategy is sound and clear and the various elements of the risk management framework are in place it will help the efficiency of this process e.g. it will be easy to decline risks which:

- do not fit the strategy;
- are outside risk concentration limits or other policy parameters;
- cannot be adequately mitigated.

In the same way it will be easier to price for the risk and determine the appropriate monitoring requirements for those risks that are taken on either with or without mitigants.

Saying no is more risk avoidance than risk management, but may well be the best option, and requires no more discussion. We shall concentrate therefore on the area of risk mitigants and monitoring procedures, but should not forget the warning given in Chapter 2 that failure to identify risks will mean that management will not even get to the start of the process described in the risk loop.

**Risk mitigants**

The main risk mitigants are:

**Hedging**

Hedging means:

covering or minimizing the risk of loss through taking out contracts with another counterparty.
The two forms in which this is done are:

**Fixed contracts** – in this form a contract is entered which will be executed. A forward foreign exchange contract is a good example of this e.g. purchase of USD 1.5 million for delivery on 30 September 2002 at a rate of USD1.5 = GBP1. In this case, the delivery date and price are fixed and on the due date GBP1 million will be delivered in exchange for USD1.5 million dollars.

The downside of these types of contract is that they are fixed, which means that the benefit of more favourable rates on the due date will be foregone. If, for example, the current or spot rate on 30 September 2002 was USD1.45 to GBP1 the USD1.5 million would be worth about GBP34,000 more. However, this extra would be forgone as the deal must be completed at the contracted rate. A way to allow companies to benefit from upside risk but protect themselves against downside risk is to use options.

**Options** – in an option a premium is paid up front which allows the buyer to call for delivery at an agreed strike price on a delivery date. The option will be called only if it is more favourable to do so than use the market price on the delivery date. In the above case, if an option was taken out and the market price was better than the option rate then the exporter would let the option lapse and deal at the spot price.

Both forms of contract have been used to hedge price risks for exchange rates, interest rates, commodity prices, etc, for quite some time. More recently, coverage has been extended to areas such as electricity and gas prices, weather risks, even catastrophe risk, and so on. Markets are wide and deep in some areas but are generally restricted to the major economies. In emerging markets, even taking out simple hedges such as forward exchange contracts is not always possible and is thus of limited use.

Another area that is getting more interest is the use of real options. Real options operate in a similar way to options described above but have application for non-financial risks. Like options they confer the right, but not the obligation, to take some action in the future. Real options will exist where a company has made some investments in the past which provide it with opportunities to take a future action which it could not otherwise do. A good example in an emerging markets context would be setting up a subsidiary in a country at a time when the local market is not well developed. Having such a presence gives it the opportunity which it can exploit quickly if that market develops and protects against the risk of losing competitive advantage. Oil companies spending large sums on prospecting for oil is another example. Having reserves is a real option which protects against existing fields running down more quickly than expected or demand for oil...
increasing and not being able to meet it. Most companies have these options but do not evaluate or manage them in a systematic manner.

Hedging is a subject which has had a fair amount of adverse press comment. There have been some high profile legal actions such as those illustrated in the Bankers Trust case study below. These cases have led to both financial and reputational loss to the sellers of options and, in some cases, impacted their future viability.

**Bankers Trust – no more**

In the mid nineties Bankers Trust was sued by Gibson Greetings and Procter & Gamble as a result of large losses incurred on a series of option contracts that they had been sold by Bankers Trust.

Bankers Trust paid out substantial damages to both parties as it became clear that they had failed to explain fully the nature of the risks associated with these contracts.

The publicity surrounding these cases had a serious impact on Bankers Trust’s reputation. The long term result of this was its loss of independence when it was acquired by Deutsche Bank and ceased operating under its own name.

Unfortunately, events such as those highlighted above have led some financial managers to adopt a policy of avoiding the use of hedge instruments altogether, which is somewhat short-sighted – it is a little like driving without seat belts. Hedge instruments can protect an organization against downside risks, particularly in the event of unexpected price movements when used appropriately.

Problems that have surfaced in the press have usually related to complex and inappropriate hedges sold to finance directors who did not understand the risks involved. Often they were pressed into taking out contracts by sales people who were concerned with hitting short term targets. In some cases, finance directors unknowingly sold options to financial institutions which exposed them to unlimited downside risks.

As we have mentioned, the Asian crisis is a good example of a situation where exchange rate hedges would have protected the solvency of companies from unexpected movements in the Thai Baht/US dollar rate. In practice, very few were taken because of the expectation that future rates would continue to operate within a narrow range of prices – a good example of past experience not bearing a good prediction of future behaviour.
Insurance

Premiums are paid by companies to their insurers in order to protect them against the financial consequences of events which could have a significant impact on their businesses – fire destroying a factory, floods damaging a restaurant, an accident to a ship, an aeroplane crash, a successful malpractice suit, etc.

The important thing to note is that insurance only covers events that might happen. Insurers cover this risk by taking a large number of small premiums and creating a pool of funds to pay claims. For larger risks, they take large premiums and offload the risks to other insurers (re-insurance). Car insurance would be a good example of the former and aircraft of the latter.

Insurance has been around a long time and is well known, so we do not need to dwell on this area. One aspect worth mentioning, however, is the trend for larger companies to use self insurance to manage this risk by collecting premiums from their business units and retaining them rather than paying an insurer. For large organizations this may be a more cost effective way of managing risk but may not cover everything in the event of a catastrophe. Larger companies are likely to have a mix of self insured and externally insured risks.

Security

By security we mean something that can be used to offset a financial obligation in the event of non-payment. This can take many forms including:

- **Tangible assets** – property, vehicles such as cars, ships or aircraft, gold, jewellery, etc;
- **Marketable securities** – Treasury Bills, government stock, stocks and shares, bearer bonds, etc;
- **Guarantees** – personal, corporate or bank.

These will only be of value if they can be turned into cash at the time of need. This requires them to have value, a willing buyer, and the appropriate documentation in place to sell them or enforce performance in a court of law.

Security is a useful mitigant but care is needed on valuation and enforceability. Legal mortgages over a property will usually be good security, for example, but personal guarantees would not, as people give them quite readily but often resist paying under them.
For companies dealing with emerging markets, risk mitigation is available from government and parastatal agencies as well as some private sources. There are a variety of types of cover available which incorporate insurance and guarantees. Short term trade business can be covered for both counterparty risk on the buyers, as well as political risk on the country exports are going to. For long term projects there is often a long bidding process, and support from agencies such as the US Exim Bank or the World Bank may be needed to put together an attractive package for the buyer as well as providing risk mitigation to the seller.

The type and level of cover that companies take will depend on their views of the risks involved and the costs. Companies happy with normal commercial risks may simply buy political risk coverage, the cost of which will vary with the perceived level of risk. As the Asian crisis unfolded, rates shot up though subsequently came back down again.

**Renegotiate**

Winning business involves much negotiation on areas such as price, quality, quantity, delivery dates, etc. Making a decision on whether to accept the deal involves weighing up the risks and being confident that the terms and conditions can be met with adequate profit and minimal downside. In many cases the buyer and seller do not have equal power and it may be a take it or leave it situation, but one way to mitigate potential risks is to renegotiate.

Ways in which this can be done are through:

- changing any of the variables mentioned above;
- adding clauses which permit changes if there are unexpected changes in circumstances e.g. the price of raw materials rise sharply;
- putting in place covenants;
- establishing penalty clauses.

In a competitive environment the ability to obtain any of these concessions will be limited. If you are a monopolist you can often dictate terms.

**Sell or transfer risk**

Historically, companies have simply taken on risks and, other than insuring or hedging them, have held them until they have run off or crystallized into a loss. Exceptions are having debt in the form of a tradable instrument such as a bill of exchange which can be sold in markets which have existed
for hundred of years and the markets for bonds and shares which are ways in which companies have always shared business risk with investors.

Apart from the above examples, it has generally not been possible to develop markets for selling risk because of lack of available documentation. In recent years, markets have developed making it possible to take on risk and either sell it off immediately or hold it and sell it later. For this to happen there are a number of prerequisites:

- the risk must be clearly defined – corporate bonds, mortgage backed securities;
- riskiness must be quantifiable – triple A rated bonds or junk bonds;
- legal documentation must be in place – in order to ensure rights and obligations are well define;
- the price is right – the buyer must pay a price that leaves the seller with a profit (unless the seller expects the risk to deteriorate and wants to cut his losses).

Securitization

In developed markets such as the US and, to a lesser extent, the UK and Europe, the market for risk has become quite liquid. This has happened through development of securitization. This involves packaging up portfolios of similar types of risks with predictable risk profiles and selling them to investors.

Typical products are mortgage loans, credit card receivables and motor vehicle loans. In many cases, these are originated by specialist companies new to the market that can compete effectively with traditional lenders such as banks – so called disintermediation.

So far this technique has not been used very much in emerging markets as the size of the markets is too small and it is not as easy to predict the risk characteristics of the pool of borrowers.

In securitization, the assets created are usually passed to a special purpose vehicle and the originator holds nothing on its balance sheet. A more recent development is credit derivatives which involves the sale of the credit risk but the retention of the asset on the lenders books. This is not
unlike taking insurance but there are subtle differences. As with securitization this is largely confined to developed markets but increasing interest is being seen in emerging markets.

Companies’ desire to buy and sell risk has increased significantly in recent years and has extended to a much wider range of risks than in the past. This has been a prime driver of the increased level of investment in risk measurement systems and models because being able to quantify and price risk better opens up more possibilities for risk managers. We can only expect this to increase. For emerging markets there are increasing opportunities to sell risk but at the time that companies are looking to lay off risk the price rises and the number of potential buyers declines, much as investors in emerging markets’ stock exchanges tend to flee when sentiment turns against them.

Contingency plans/backups

A number of the above mitigants are financial in nature but many risks are physical. Risks can be mitigated by taking actions to prevent problems arising while other actions may reduce their impact should they occur. Consider our call centre – the key elements we have said are communications, computing, premises and people. Buying good quality equipment should help prevent breakdowns occurring but cannot eliminate potential problems completely. In emerging markets power can be a problem and interruptions are not uncommon. There is little that can be done to stop power outages but having uninterrupted power supply units (UPSs) can ensure vital computer systems continue to function and backup generators can keep lights, air-conditioning, etc, running. These problems are not unique to emerging markets but the frequency of problems occurring is likely to be much higher and their causes may be more varied, so in practice companies often have backups to backups.

These examples are low level risk mitigants that are commonly put in place in operational areas around the world. Most operations managers will ensure backups are in place or there is overcapacity in critical areas to ensure continuity. However, what happens when there is a major incident? Companies with robust business continuity or disaster recovery plans are the ones that survive. These are needed when there are fires, earthquakes, floods or other disasters that put offices or production units out of action. They are needed in developed economies as well as emerging market ones. In the latter economies problems can also arise due to civil disturbance, war or similar which affects parts or all of the country. Sometimes demonstrations are targeted against one company and can go on for very lengthy
periods. In some cases, there is no option but to abandon operations, in which case crisis plans need to be invoked. For less extreme events, people will want to protect their investment and keep serving their customers in some form. Detailed and tested plans are important risk mitigants. They protect against loss of business by keeping disruption to a minimum.

**Doing nothing**

We have said before, but it is well worth repeating, doing nothing may well be the riskiest thing that people do because to do nothing means that you are actually accepting, rather than mitigating, the risks that you face. It may be the appropriate thing to do, for example where the cost of mitigating risk is more than the maximum downside risk or the possible impact is low and the probability of the event occurring is very small. Provided the risks have been identified and all options considered, then this may be the best way forward. In practice, many managers do nothing in ignorance either of the risks or the ways in which they can be managed.

Techniques alone are, however, not enough to ensure that risks are effectively managed in an organization.

**Risk culture**

A sound risk framework is a prerequisite for managing risk effectively but it is not sufficient. This merely provides the infrastructure or hardware, to use a technology metaphor. As with hardware there is a need for software – risk culture – to make things work and ensure that risks are well managed.

The key soft issue is people. People issues are paramount in risk management – there is a need for the right people with the right skills, knowledge and attitude to identify and manage risk. The need for good people who can respond to ever changing circumstances is constantly growing and is imperative in emerging markets where things can be so different.

There are other issues however. Figure 4.7 (loosely based on Johnson and Scholes) illustrates the factors involved in determining the risk culture of an organization. A strong risk culture requires that each of the factors shown in the diagram are addressed and there is a satisfactory balance between them. Having good people alone, for instance, is not enough. They need to be trained and given the right incentives. Clear and adequate policies and procedures must be defined and put in place. There must be
clear communication of what those policies and procedures are, what group strategy is, and what their own objectives are. When they step out of line they must expect to be disciplined.

Fig 4.7  Risk culture determinants

Achieving a satisfactory balance between all these elements is not easy however, particularly for a large organization and especially for ones that operate across many territories. It takes a long time to develop a strong culture but it can easily be undermined if there are inconsistent messages or continual changes, together with a focus on short term goals. The following will not help:

- senior management saying one thing and doing another (the rules do not apply to me);
- failure to follow policy and procedures not being punished;
- remuneration policies rewarding short term revenues not achievement of long term objectives;
- inadequate resourcing of risk management areas (usually the case where it is considered an overhead not a value added activity);
- poor communications.

The result will be to encourage people to act in their own rather than the organization’s interest. Personal interests tend to have shorter time horizons leading to short termism.

Having a strong risk culture is not an end in itself. What is important is the behaviours that it drives in pursuit of an organization’s goals. Figure 4.8 shows how we can extend the above risk culture determinants to build a more dynamic and meaningful model.
The problem is that there are conflicting forces at work which are particularly dangerous where there is a disconnect between the organization’s strategy and the realities of market opportunities. Pressure for short term results may mean taking on higher risks than we really think we should, because meeting immediate goals has higher priority, and may mean we keep our job or get that higher bonus. Where there is a strong culture this will not happen as there will be push back to senior management to get the targets changed. Unfortunately this does not happen often enough to prevent disasters occurring one or two years down the line.

One way to counterbalance a weak risk culture is to have a stronger risk framework. Where the risk culture is strong, people will do the right things without being told.

New risks for old?

Managers decide whether to accept, mitigate or decline risks. We have explained some of the more common ways in which risks can be mitigated but it must be realized that most risk mitigation techniques simply transform risk, they do not eliminate it, e.g. transferring risk from one party to another means new or additional risks are created. A good example is
insurance. Taking insurance is expected to protect against loss, but new risks are created when insurance is taken out. These are:

- Credit risk – loss protection will only be effective if the insurer is still in business and has the funds to pay the claimant after a claim is made.
- Operational risk – payment will only be forthcoming if the claimant is able to satisfy the insurer that the claim is valid. This will require completion of a form and the provision of evidence of the claim. The insurance company may well decide the claim is not valid and refuse to pay.

The same situation arises where guarantees are provided as security – they are only worth anything if the guarantors are willing and able to play when the claim is made. Banks taking property as security are only protected if the market value of the property (market risk) has not fallen below the level of the debt and they have the correct documentation to repossess and sell it (legal and operational risk, possibly reputational risk also).

Without fully assessing all these new risks, managers may be under the impression that they have mitigated the risk when they have not. In essence, this is no different from the problem raised in Chapter 2 that risks which are not identified will not get managed.

Risk transference is now big business, insurance for instance, but new forms of it can give rise to new and significant risks as the next example illustrates.

### Smoke and mirrors

Credit derivatives are one way in which credit risks are transferred from one party to another. The volume of these transactions has risen sharply in recent years and this has led to concerns that the overall level of risk in the banking system has increased rather than decreased.

A reason for this is accounting risk because there is little transparency on what risks have been transferred from one party to another. This means it is increasingly difficult to get a clear picture of the actual balance sheet risks of the buyer of risk protection, and the off balance sheet position of the seller. It is likely that increased disclosure will be introduced to address this concern.
Clearly, therefore, managers must be aware not only of the risks that they are trying to mitigate but also new risks they may create as a result. The case of Bankers Trust and Procter & Gamble illustrates only too clearly what the cost of overlooking this fundamental can be. Risk mitigants only really have value if they reduce the overall level of risk at a reasonable cost.

**The cost of not managing risk**

We have presumed that there is a downside to not managing risk effectively but have not explicitly stated what it is. Poor risk management can lead to many possible impacts but at the end of the day, they will all result in either reduced revenues or higher costs or both. This will produce reduced profits or losses and eventually may lead to closure or takeover. Depending on the nature of the business and the cause of the downturn this transition can be a slow decline or a sudden death.

Sudden death for an organization tends to occur where it has one or more critical dependencies. Financial institutions, for example, are usually higher leveraged and depend on their reputation and risk rating to obtain funding but adverse news can lead to liquidity drying up overnight. Without liquidity they will collapse quickly unless there is regulatory support. Alternatively, a company hit out of the blue by a catastrophic event may be unable to recover from it. Recently we have seen a number of high profile dot com failures as a result of their running out of funds and not being able to obtain new finance.

Slow death can occur over an extended period for a variety of reasons. Companies may have a poor product offering in the market which means that sales decline but costs do not, leading to reduced profitability. Lower profits mean an inability to invest in new products producing a further decline in market share and profitability. Reputation starts to decline leading to good staff leaving and an inability to attract good replacements. Lenders start to become cautious and credit becomes harder to obtain and so on. A downward spiral can result which starts slowly but becomes ever faster. Investing in projects in emerging markets that are significant to the size of company can drain cash and resources and trigger slow death if things change in their home market and management take their eye off the ball while concentrating efforts on their new venture.

*Protecting the downside*

We have said earlier that businesses take risks and, given that we do not all have perfect foresight, some decisions will not work out as expected. This
means that losses will occur, sometimes those losses will be sizeable due to extreme events occurring. Good risk management will protect a business by limiting the size of its exposure to such risks, but there are other things than can be done to protect a company from the consequences of adverse events. Some areas that management should address are:

Contingency planning – as we have said above, when something unexpected happens, companies that have tried and tested contingency plans are able to minimize disruption to customer service. These are companies that had thought the unthinkable and did something about it. Some became stronger as a result.

Bomb blast

In the early nineties London was hit by a series of bomb blasts. One virtually destroyed the Baltic Exchange in the City and damaged nearby offices.

The bomb went off over the weekend but on Monday morning a few companies were able to take out advertisements in the national press “open for business as usual” as they were able to put into practice their business continuity plans.

Those businesses which did not have such foresight did not fare so well as people turned up on Monday morning considering what to do rather than knowing what to do.

Strong financial position – the first line of defence when things go wrong are current profit streams. If these are exhausted, a company needs adequate capital reserves to cushion losses. In the short term, however, it is liquidity that is more important – the ability to pay the bills falling due today. Adequate cash reserves will provide an immediate cash resource as will undrawn credit lines, provided they are not withdrawn. Assets which can be sold quickly or shareholders with deep pockets provide further fallbacks. It is not surprising that companies which are overstretched get into difficulties quickly. In some cases the cause is simply growing too fast. Non-financial managers, and particularly owner-entrepreneurs, often have difficulty understanding that a company growing fast will be a cash drain even if it is showing healthy profits. Without appreciating this they cannot understand why a risk manager would recommend turning down additional business. The result is that overtrading is a common cause of business failure.
Goodwill – companies that have a good reputation are more likely to survive what is perceived to be a temporary setback. Customers, suppliers, regulators will provide support where they think it is in their interests to do so. Investing in building relationships during the good times can pay dividends when things go wrong. Developing brand loyalty is one way of doing this, but in emerging markets people are less likely to pay premiums for branded goods because they often cannot afford to do so, at least not in the mass market.

**Fraud**

We have touched on fraud briefly but it is worth a further mention. However good your risk management framework is or however strong the risks culture it is difficult to isolate yourself from fraud, either from internal or external sources. Sound controls, good reporting and inquisitive people will minimize the risk, particularly where one individual is trying to perpetrate a fraud. Where there is collusion either within an organization or between an outsider and an insider, it is more difficult to detect. In some cases, fraud results from sustained and complex activities – credit card fraud being a good example – but more often than not it is a simple story of a quiet and unassuming employee or a star performer being allowed too much licence. Rules are broken but no one notices. What started small escalates. The following story is not untypical.

In April 2001, it was reported that an employee had fraudulently withdrawn USD 8.5 million from customer accounts over a period of several years at Deutsche Bank in New York.

The employee was a private banking customer relations manager who had quietly and efficiently done his job while dipping into clients’ funds on a regular basis. He had done so despite “two signature” rules as the counter signatories did not undertake proper checks on the authenticity of transactions.

Deutsche have reportedly strengthened their controls since this case came to light.
In emerging markets fraud, particularly internal fraud, is a significant area of concern, as is counterfeiting of goods which is rife in some countries. For some operations, money laundering is another cause for concern.

**Conclusion**

We have covered in depth a variety of areas under the heading of managing risk. Businesses survive and prosper by taking risks, provided they are managed effectively. To do this they must decide what risks they want to/can afford to take by setting an appropriate strategy which must be supported by putting in place a risk framework that is robust and adequately resourced. Within that, individual decisions are made and risks can be mitigated by using the variety of tools and techniques which have been outlined. Once decisions are made, however, the job is not over as it is necessary to constantly monitor risks and reappraise those decisions.

Apart from addressing the hardware, management must address the software by ensuring there is a strong risk culture which encourages business development but in a controlled and disciplined way. Failure to do so will lead to either a fast or a slow demise when things go wrong. In this regard a useful reference is the rules of risk management set out in Appendix 1 which neatly encapsulates some of the key points covered in this chapter.

In emerging markets, the approach to risk management must be different because the types of risks and the ways in which they can be managed are not the same as in developed economies. The next chapter will look at what it is about emerging markets which causes this.

**Summary**

The key messages from this chapter are:

- Risk management starts with setting the right strategy.
- Strategy setting must involve risk and must not be dictated from the top.
- A robust risk framework is needed to support the strategy.
• The more aggressive the strategy the more important the risk framework becomes.

• Historically, risk has been managed from the centre (command and control) but this is not the most appropriate model in an increasingly volatile environment.

• Decentralization will help risk management operate more effectively at the front line but controls are still needed, as are better quality people.

• The types of risk management frameworks adopted will vary according to size and complexity of the organization.

• Whatever the type of risk framework adopted there are a number of key elements that need to be addressed, including checks and balances, policies and processes, limits and roles and responsibilities.

• There are many tools and techniques for managing risk but often they simply transform the risk rather than eliminate it and, in many, create new risks.

• Doing it right will lead to satisfactory rewards but failure to address risk effectively will lead to losses and eventual demise, the only question being whether death is quick or slow.

• Building a robust framework is not sufficient. People issues and risk culture must be addressed.

• The right strategy, supported by a robust risk framework which is implemented well will reduce the probability of an organization being hit by unexpected events and will help minimize the impact of any adverse events. It will not eliminate the risk of fraud.

References


There is no return without risk – rewards go to those who take risk. Intelligent risk taking is to be encouraged by managers, not stifled.

Be transparent – risks need to be fully understood. A risk that is not understood is a risk that should be avoided.

Seek experience – risk is measured and managed by people, not mathematical models. No new model is ever worth the sound judgement of an experienced risk manager.

Know what you do not know – every model is filled with assumptions. Know those assumptions, and actively question them.

Communicate – risks need to be discussed openly. A culture where people speak about their risks will be more successful than one that discourages an open risk dialogue.

Diversify – multiple risks will produce rewards that are more consistent. Organizations get into trouble when one risk dwarfs all the other exposures they are taking.

Show discipline – a consistent and rigorous approach will beat a constantly changing strategy. The temptation to change your goals as markets change must be avoided.

Use common sense – it is better to be approximately right than precisely wrong. Do not spend your resources on improving the minutiae – concentrate on those issues that make the biggest difference.

Get a risk grade – return is only half the equation. Decisions should be made only by considering the risk and return of the possibilities.

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PART TWO

Emerging markets and risk management
“Emerging markets constitute the major growth opportunity in the evolving world order.”
DAVID ARNOLD, JOHN QUELCH

Introduction

So far we have concentrated on investigating the nature of risk and the key issues in relation to identifying, measuring and managing risk, and have included some examples and commentary on how operating in emerging markets can make these activities more difficult. In Part Two, we will look more deeply at the nature of emerging markets and what makes them so interesting from a risk perspective. Interesting because businesses largely exist to make profits from taking risk and it is generally accepted that risks in emerging markets are higher than in the developed world. Higher risk will be associated with higher profits but only if risks are managed effectively.

We start this chapter by addressing the question of what are emerging markets, before looking at culture and language in Chapter 6 and risk management in emerging markets in Chapter 7.

What are emerging markets?

The term emerging markets is relatively new but it is one that is widely used. It is, however, rarely defined so it is not surprising that there is no commonly accepted understanding of what the term means. A look at any
list of countries that are described as emerging markets gives a clue as to why a simple definition is not easy to develop. In these lists you will often find countries such as China, Botswana, Chile, Singapore, South Africa, Hungary, Jordan and so on. On the face of it they seem quite diverse so how can we come up with a sensible definition of emerging markets?

One way would be to describe emerging markets as simply “all those countries not considered developed”. Developed here meaning essentially the major European countries plus the US, Canada, Japan, Australia and New Zealand. This is a rather negative and not particularly useful approach, however, and would include all the remaining countries in the world.

Another approach would be to simply think of the term as an updated, and more politically correct version, of the terms used in the seventies and eighties such as Third World, lesser developed countries (LDCs) or under-developed countries. There is possibly some truth in this but again it is not particularly helpful.

A more useful way to look at defining emerging markets is to consider some of their key attributes and see what help this gives us. The major ones would be:

*Level of income* – this is a commonly used measure. The World Bank, for example, uses Gross Domestic Product (GDP) per head as a measure to classify countries as set out in Table 5.1.

<table>
<thead>
<tr>
<th>Classification</th>
<th>GDP per head USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>&lt; 755</td>
</tr>
<tr>
<td>Lower Middle</td>
<td>755 &lt; 2,995</td>
</tr>
<tr>
<td>Upper Middle</td>
<td>2,995 &lt; 9,265</td>
</tr>
<tr>
<td>High</td>
<td>&gt;= 9,265</td>
</tr>
</tbody>
</table>

Source: World Bank

Unfortunately, there are problems with using such numbers including:

- obtaining accurate measures of GDP and population numbers is not that easy in a number of emerging markets, particularly those with a large “black economy”;

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*Table 5.1 World Bank classifications*
conversion of local currency numbers to USD for comparison purposes are vulnerable to exchange rate movements.

In addition, simple comparison of GDP numbers is rather one-dimensional, particularly as it does not take into account the cost of living. One way round this is to use Purchasing Power Parity (PPP) data. This involves comparing the actual cost of living and adjusting raw GDP data to reflect this. On this basis, for example, China’s GDP per head would increase from USD 620 to USD 2,290 (1995 data). In comparison, the Philippines would increase from USD 1,050 to USD 2,850. This helps but one problem remains, several countries often classified as emerging markets have income levels in the World Bank’s upper bracket – Hong Kong and Singapore, for example.

Growth rate – one reason that emerging markets have been considered attractive has been that they often exhibit a high rate of GDP growth. Many Asian economies averaged 4–7 per cent growth during the eighties and nineties for example, compared with 1–3 per cent for developed economies, but this has not been the case for all emerging market countries. Many economies have shown lower or, in some cases, negative growth rates at some stage in the past ten years in Africa, Eastern Europe and Latin America. Most Asian countries saw negative growth rates during the Asian crisis in the late nineties.

As with using GDP, the use of growth rate numbers alone will not help us very much in coming up with a list of emerging market countries, particularly now that growth rates are so volatile.

Stage of development – this is a factor that fits more closely with the word “emerging”. There are a number of dimensions we could consider:

- the degree of openness in the economy as measured by the degree of deregulation, privatization of state enterprises, or the extent of tariff and other barriers to trade;
- the size of the market in terms of goods such as cars, telephones, electronic goods, etc;
- the state of financial markets including the existence, size and degree of concentration of the stock market, and the size and depth of local bond markets.

These all play a part in defining how developed an economy is. Development is usually associated with reaching key trigger points at which the consumption of these types of goods suddenly rises sharply because they become
affordable by a larger middle class customer base. There is a clear link here with GDP growth rates and the absolute level of GDP. The development of financial markets is something that many countries now aspire to, as can be seen from the fact that in 1996 there were 60 emerging markets with their own stock exchange – twice the number ten years earlier. In the 21st century, the emphasis is on increasing the depth and transparency of these markets and developing bond markets to complement them.

**Stability** – a defining characteristic of many emerging markets is a lack of stability, either economically or politically.

What do we conclude from considering these various measures that might help us define the term emerging markets? Can we reach a conclusion? Yes and no. Each country that is generally considered an emerging market is likely to have some characteristics that will fit with one or more of the above three criteria, but not all. It is best, therefore, to use a broader definition that can accommodate the diverse range of countries which are generally accepted to be emerging markets.

We will define emerging markets as:

> those countries which have started to grow but have yet to reach a mature stage of development and/or where there is significant potential for economic or political instability.

The key defining characteristics, therefore, are maturity and instability. Let us look at each in turn.

**Maturity**

Maturity is used to describe one of the stages in a continuum or life cycle of development. The stages are birth, growth, maturity and decline which follow a pattern such as that depicted in Fig 5.1. This pattern is seen in many situations including the launching of new products, the growth and decline of industries, the rise and fall of sports teams and so on.

In the context of the stage of development of a country, the key measure is usually GDP, as income and development are closely linked.

In terms of our definition we would consider emerging markets as only those that have actually started on the growth phase. This means they have moved beyond subsistence farming and primary extraction to develop their own industries and have started opening up to the world economy. Without some sort of floor of this kind, albeit somewhat imprecise, we
would not be further ahead than defining emerging markets as all those which are not developed. We do need to screen out those countries which for economic or political reasons are not going to be attractive for businesses to invest in – Sierra Leone, Burkina Faso and North Korea cannot be considered emerging markets today. They probably will not be in ten years’ time either.

![GDP($)](image)

**Fig 5.1** Life cycle

In terms of Fig 5.1 we can position emerging markets in the growth phase but they may well be little more than just past the birth stage or not far off reaching maturity. Most developed countries would be towards the top of the growth stage or in maturity. Few, if any, could be considered in decline though a case could be made for Japan after a decade of near stagnation and fears of deflation. As with all classifications there are always some anomalies. Singapore, Hong Kong and Taiwan, for instance, which have GDP per capita levels higher than some developed countries. Despite this apparent anomaly, most people would classify these three countries as emerging markets. To see why, we need to consider the second key factor.

**Instability**

The concern with many emerging markets is the uncertainty over what might happen in the future. This uncertainty may be political or economic, sometimes it is both.
Political uncertainty arises where there is a history of instability or a high probability that change will occur. The causes of this instability are many and include religious or tribal tensions, repressive regimes, domestic insurrection, war or threat of war, economic problems, etc. Many emerging markets are run in a dictatorial manner by charismatic leaders kept in power through the support of the military and the lack of credible opposition. The legitimacy of these types of regimes has increasingly been challenged in the past decade as people have seen their own situation worsen at the same time as the ruling elite have enriched themselves. In recent years, there have been a number of cases where long running, but unpopular, leaders have been deposed, with or without bloodshed – the Philippines, Russia, Pakistan, etc. Change in leadership, however, does not always bring the benefits that people expect, as the following example illustrates.

Change for the good?

After more than 30 years running Indonesia, President Suharto was forced from office in 1999. This came about, in part, as a result of a popular uprising and, in part, through the loss of support of the military.

After Suharto's expulsion the country has hardly settled down to any period of political stability. After an interim president from Suharto's party took charge, elections were called and there was a sharp swing away from the Golkar party. After much bargaining and an extended period of time, a new president Abdurrahman Wahid was sworn in but his presidency was rocked with various scandals, calls for resignation, new protests and impeachment proceedings. Eventually he was forced from power but in a constitutional manner without the demonstrations and civil unrest that led up to Suharto's departure.

The enthusiasm which greeted Suharto's demise has been replaced with dismay at the lack of progress. A similar story has been seen in many countries where despotic leaders have been overthrown but people have not found themselves free or economically better off – this has been true in many of the former communist countries in Eastern Europe, for example. In Africa it has also been a familiar story in many countries that were freed from colonial control throughout the sixties and seventies.
Economic uncertainty may arise as a consequence of government actions or be the result of inherent vulnerabilities – concentration in a few industries or dependency on exports or aid flows, for example. The Asian crisis well illustrates how interdependent some emerging markets have become and how quickly the swing from boom to bust can be. The problems in Indonesia were largely triggered by economic problems caused by a rapid fall in the exchange rate. In 2001, Singapore swung into its deepest recession for decades after bouncing back from the Asian crisis with 10 per cent growth in 2000 due to collapsing electronics exports. Its future direction is now uncertain. Turkey is another economy recently in crisis.

Turkish Delight?

During 2000, progress was being made in addressing some of Turkey’s economic problems including an annual rate of inflation which had averaged over 70 per cent for ten years or more. The IMF provided support and structural changes were promised.

In early 2001, there was a fall out in the government which prompted speculation against the Turkish Lire. The government had insufficient reserves to hold out against the speculators and the currency dropped more than 30 per cent overnight. This quickly undid a lot of the good work done in the previous year and led to a rise in the rate of inflation which had been falling steadily.

There is no immediate prospect for improvement until confidence is restored which is difficult with a coalition government in place.

This example shows the interconnections between political and economic factors. A strong government is usually preferable to a weak one because change can be forced through. Where there is weak government change is hard to effect, particularly if the change has economic consequences. The backsliding on promised reforms in a number of Asian countries, particularly those with elections coming up post Asian crisis, illustrates this quite clearly.

It is because of their vulnerabilities to either political or economic factors that some of the higher income economies are classified as emerging market countries. In the case of Hong Kong, reintegration with China causes some concerns over the future of its separate economy, while China continues to cast a shadow over Taiwan. Singapore is very stable politically but, being an island state with few natural resources, it has proven vulnerable to economic downturn as a result of falling trade with its main market, the USA.
Emerging markets, therefore, include those which are in the growth phase of the development cycle and are vulnerable to internal or external forces that make them potentially unstable. They do not include those countries which are desperately poor and have little prospect of moving beyond this stage in the foreseeable future.

The nature of emerging markets

There is no “typical” emerging market that we could describe to you. They are all different but there are, however, a number of characteristics which, in varying degrees, are likely to be found in these countries. A convenient way to look at this is to group these characteristics. We shall use the headings physical, social, economic and political to do this and will look at each of these in turn.

Physical

Emerging markets exhibit a wide range of physical attributes that in one way or another tend to place some limitations on the growth opportunities of a country or make it vulnerable to external influences. Some of these factors are:

- geography – large or small size, inaccessible regions or barriers to travel, distance from developed markets;
- dependency on or vulnerability to weather patterns – monsoon rains, El Nino effects;
- vulnerability to natural disaster – floods, earthquakes;
- poor infrastructure – transport, utilities, etc;
- reliance on a few agriculture and/or primary commodities.

Many emerging markets are found in tropical zones or in areas of the world more vulnerable to natural disasters. Most developed countries are found in temperate zones though there are obvious examples such as the US and China which are very large and have both temperate and tropical regions and are both subject to storms, floods and earthquakes.
Social

The social fabric of a country will support or hinder its development. Some of the factors of importance that differentiate emerging markets are:

- language – often there are many local languages but a foreign language is needed to conduct international trade (English, Chinese, Spanish or French being the most common);
- tribal divisions;
- religion;
- population growth;
- skewed population distribution – large percentage less than 15 years of age;
- poor health (AIDS in some countries) or poverty;
- concept of the extended family (provides safety net);
- education levels low.

Many emerging markets have more than one language and are divided by tribal or religious affiliations. India has more than a dozen major languages and hundreds of dialects which has meant English has become the most practical language for business, even within the country. Population growth is a problem in countries with lower education levels and higher death rates. As income levels rise this usually improves but how to achieve higher income levels is the question. AIDS is a significant problem in Africa but social and cultural barriers prevent there being easy solutions. Giving away condoms can be done but they are of no value if unused.

Economic

Sound economic performance requires the country to have some competitive advantage to start with, which is then effectively exploited. Good management of the economy is important, but some or all of the following may still be evident:

- skewed income distribution;
- managed economy – subsidized prices;
- dependence on primary exports and/or tourism and/or aid flows for foreign exchange;
- net oil importers (few notable exceptions);
• protected home markets;
• IMF/World Bank support required;
• large black economy;
• high unemployment or underemployment (but no or limited state support);
• poor quality/quantity of data – lack of transparency;
• state control of large parts of the economy – limited state sell off;
• small or no stock exchange while those that exist are heavily influenced by trading in a few stocks;
• limited amount of stock in public hands;
• few large conglomerates operate in many sectors – including banking;
• limited tax base – tax avoidance common;
• dollarization – the common use of US Dollars in lieu of local currency or the establishment of a more formal link between the two;
• two tier exchange markets;
• borrowing by the state and private sectors often done in foreign currency;
• high percentage of export proceeds committed to financing debt.

Some of these result from poor stewardship by the government of the day. In some cases there is the will to change e.g. to reduce the budget deficit by cutting subsidies, but this is politically unacceptable. How often have you heard of food riots when it is planned that subsidies on bread, rice, sugar or petrol are to be reduced?

**Political**

In only a few emerging markets has democracy been the norm for more than 10–15 years. Politics tends to be dominated by powerful leaders who run things for their own or their families/cronies benefit. This is slowly changing but some of the following are still likely to be found:

• stable but despotic/one party rule or regular change in government;
• democratic but not free elections;
• multiparty governments with changing factions;
• historical legacy – colonial past or former communist state;
• potential for violent overthrow;
• patronage/cronyism;
• corruption;
• control of the press though this is being undermined by the Internet and satellite television;
• strong influence of the military;
• lack of legal framework or laws in place but not enforced;
• contracts not always honoured;
• internal conflict/repression;
• war or threat of war;
• many regulations, together with a propensity to bring out new ones without consultation or thinking them through.

Some of these characteristics are innate and cannot be changed e.g. the geography of the country, natural resources, climate and so on. Others have their roots in history – post colonialism or, more recently, post communism. In several cases, countries have actually gone backwards as a result of long periods of poor rule – Marcos, Suharto, Abacha, Idi Amin, and Saddam Hussain are leaders who have overseen a deterioration in their country’s prospects. Long periods of autocratic rule are, however, not all associated with a lack of progress – Lee Kuan Yew in Singapore, for example, built his country from a low level to its current high standard of living in a generation within a one party state.

What is important is that the consequences of the above factors is generally a weak or vulnerable economy which has all, or some, of the following attributes:

• under-developed financial systems – including under-capitalized banks with poor lending policies and controls (often state run or parts of business groups);
• occasional illiquidity;
• shallow or non-existent markets – inadequate bond markets for the government or the private sector to raise funds or lack of markets to hedge risks;
• price volatility;
• lack of hard currency;
• high budget/trade deficits as a percentage of GDP;
• inflation, sometimes hyper inflation;
• regular devaluation or pressure to devalue (speculation against the currency).

These all lead to vulnerability to sudden changes in exchange rates, interest rates, commodity prices, demand for commodity exports, bad weather or natural disasters. When such events occur, reserves may not be sufficient to weather the storm or the government may lack the political capability or desire to take the appropriate actions. The Asian crisis illustrated such vulnerabilities quite clearly.

Thailand and the Asian crisis

During the mid nineties Thailand's private sector built up a huge level of foreign currency debt that was being used to finance domestic business. This debt was not hedged naturally through exports proceeds nor were exchange rate risks hedged.

After pressure on the Thai Baht, support was withdrawn and the currency rapidly devalued from 25 Baht to the dollar to over 50 Baht to the dollar. This rendered many companies insolvent. The Bank of Thailand closed down many financial institutions and took over the running of banks weighed down by bad debts. A number of companies closed down, some were taken over, some struggle on. Domestic demand slumped and asset prices fell sharply. Growth turned negative.

Today, the country has yet to come fully out of the downturn and concerns persist that the economy remains vulnerable. The cause of this vulnerability is that the economy bounced back from the crisis on the back of growing exports, rather than growth in domestic consumption, and export volumes are dependent on demand in developed and regional economies. Domestic demand remains weak and the structural reforms needed have not been made as expected. Bankruptcy laws which did not exist previously, were enacted but they do not yet work effectively. Foreign investors not surprisingly remain wary.
Another example of a problem economy is Zimbabwe.

**Zimbabwe**

Zimbabwe is a country in Southern Africa which emerged from a period of bloody internal conflict and colonial rule with bright prospects. It had a variety of natural resources and reasonable race relations. It should have performed well, but it had a one party communist government whose ongoing mismanagement of the economy and its more recent actions have driven it to the brink.

Change started in the mid nineties when it opened its economy to market forces. Managers were able to deal with this while the economy was under reasonable control and the exchange rate was stable, but economic mismanagement over the past few years has increased vulnerability. This has escalated as a result of the invasion of farms which produced crops, such as tobacco, which are major export earners. Foreign exchange earnings have slumped as agricultural exports drop and tourism has suffered. Involvement in a civil war in the Congo has drained resources. Now there is hardly any fuel to keep the economy going, inhibiting production and movement of goods.

Behind these problems is a communist ruler who has remained in power, supposedly through democratic means but in part through control of the press and intimidation of the opposition. It is hard to see how the situation will improve until there is a change at the top, as most governments have withdrawn aid and loan support.

Having looked at some of the characteristics of emerging markets how important are they in the world’s economy?

**Facts and figures**

Table 5.2 positions emerging markets in a world context. They occupy the majority of the world’s land surface, contain the bulk of its population and supply a large part of commodity production, yet have less than a quarter of world income. In terms of stock market capitalization, the sum total of all emerging markets does not equate to that of the US or the UK alone.
Looking forward, both the absolute size and relative share of the world’s population found in emerging markets is likely to increase, albeit at a slower pace. The goal for those economies is to raise their share of GDP at a faster pace and thus raise living standards. This is achievable with the right policies and political determination to do the right things and stick with them, but it is not inevitable that this will occur, and recent evidence suggests that inequality between developed and emerging markets is increasing rather than improving.

Given that we have said that all emerging markets are different, what are the techniques that businesses can use to evaluate these various economies for the purposes of developing sales or establishing production platforms?

**Country classification**

There are a large number of emerging markets, each of which has a unique combination of characteristics that make them attractive or unattractive for companies looking to expand abroad.

There are a large number of emerging markets, each of which has a unique combination of characteristics that make them attractive or unattractive for companies looking to expand abroad. To help in deciding on where to target, it is useful to group the emerging market countries. What suits a company best will depend on its particular interest, but generally it can be done in one of two ways – looking at one or a few dimensions or by use of some sort of scoring mechanism.

| Table 5.2 Share of emerging markets in world market |
|---------------------------------|----------|
| Factor                          | Percentage |
| Population                      | 83       |
| Geography                       | 77       |
| Commodity production            | 63       |
| GDP                             | 23       |
| Stock market capitalization     | 15       |

Source: Risk management and analysis
**Single dimensional measures**

Some of the common ways to group emerging markets are to look at:

*Location* – regional groupings are a broad brush but useful approach e.g. Africa, Eastern Europe, Latin America, the Middle East and so on. These may be sub-divided e.g. North Africa, Sub-Saharan Africa, etc. Distance from current operational areas will be important but this is less of an issue than it once was.

*Income levels* – this can be done using the World Bank definitions set out in Table 5.1. Table 5.3 gives some examples of countries in the various classifications.

### Table 5.3 Income level groups

<table>
<thead>
<tr>
<th>Classification</th>
<th>GDP per head USD</th>
<th>Sample countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>&lt; 755</td>
<td>Bangladesh, Ethiopia, Ghana, India, Indonesia, Kenya, Nigeria, Pakistan, Tanzania, Ukraine, Vietnam, Zimbabwe</td>
</tr>
<tr>
<td>Lower middle</td>
<td>755 &lt; 2,995</td>
<td>Bolivia, Bulgaria, China, Colombia, Cuba, Egypt, Jordan, Morocco, Russia, Sri Lanka, Thailand, Turkey</td>
</tr>
<tr>
<td>Upper middle</td>
<td>2,995 &lt; 9,265</td>
<td>Argentina, Bahrain, Botswana, Estonia, Korea, Malaysia, Mexico, Poland, Saudi Arabia, South Africa, Uruguay</td>
</tr>
<tr>
<td>High</td>
<td>&gt;= 9,265</td>
<td>Hong Kong, Qatar, Singapore, United Arab Emirates</td>
</tr>
</tbody>
</table>

Source: World Bank
These bands may not suit all purposes, so narrower bands could be used or purchasing power parity adjustments could be made.

Political status – this can be done using a two dimensional approach which considers the nature of the political system and the degree of stability e.g. unstable democracy, stable one party rule, undemocratic but stable royalty, etc. This can be tied in with company policy – some companies, for instance, will not operate in economies that are not democratic. In some countries, laws prohibit trading with certain regimes e.g. the US with Cuba, Iraq, etc.

Economic performance – a variety of economic measures can be used including the level of inflation, the rate of GDP growth, the level of budget deficit, size of external reserves, the trade deficit and so on.

Level of indebtedness – this is a classification of countries used by the World Bank based on the percentage of debt service to GDP and debt service to export income. These are relative rather than absolute measures which suggests that countries which have high levels of indebtedness are more vulnerable to market fluctuations or unexpected events e.g. a harvest failure or a drop in commodity prices. Table 5.4 lists some of the countries falling into the various categories.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Sample of countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Severely indebted</td>
<td>Argentina, Brazil, Indonesia, Jordan, Nigeria, Peru, Tanzania, Vietnam</td>
</tr>
<tr>
<td>Moderately indebted</td>
<td>Bangladesh, Chile, Colombia, Ghana, Kenya, Malaysia, Philippines, Russia, Thailand, Turkey, Uruguay</td>
</tr>
<tr>
<td>Less indebted</td>
<td>Botswana, China, Egypt, Iran, Korea, Libya, Mexico, Poland, Saudi Arabia, South Africa</td>
</tr>
</tbody>
</table>

Source: World Bank
Market potential – size and growth rate of the market for a particular product. This is to a large extent linked to the level of GDP per head but more important is the distribution of income. It is not uncommon for income distribution in emerging markets to become skewed e.g. the top few per cent of the population having a high percentage of the total income. As this changes, as it has started to do in a number of countries, a middle market income group develops over time and this can increase demand for certain types of goods quite considerably, India being a good example.

One or more of these classifications could prove useful depending on the company’s purpose. A broader based approach, which may use some of these inputs, is to produce a country score of some kind.

Scoring methodologies
There are a variety of companies which produce country scores or ratings, though a number are only available on subscription or fee per report basis. These include well known rating agencies such as Moody’s and Standard & Poor’s, and other companies such as the Economist Intelligence Unit (EIU), Euromoney and the Institutional Investor. Many large companies have similar internal functions, particularly the large oil companies and banks, as do many governments. Some of this information is publicly available.

Each of these bodies use a different methodology/scoresheet to assess or rate countries, but their approaches are broadly similar. They each allocate scores for various factors using objective and subjective criteria that are weighted and then totalled. These various rating methods do not come out with identical results but they are generally within an acceptable degree of tolerance and the rankings of countries are likely to be quite similar. Indeed, it would be very surprising if any rating system did not have Singapore and Taiwan near the top and Iraq and Sierra Leone near the bottom.

An example of S&P’s ratings is set out in Table 5.5. This shows separate ratings for local and foreign currency exposures each showing short and long term ratings as well as an indicator for the outlook e.g. which direction are ratings likely to move in the future. Not surprisingly, ratings for countries such as Singapore and Hong Kong are good with stable outlooks and those for Argentina, Indonesia and Turkey are poor with negative outlooks.
### Table 5.5 Examples of S&P country ratings – November 2001

<table>
<thead>
<tr>
<th>Sovereign</th>
<th>Local Currency</th>
<th>Foreign Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Long term rating</td>
<td>Short term rating</td>
</tr>
<tr>
<td>Argentina</td>
<td>CC</td>
<td>Negative</td>
</tr>
<tr>
<td>Brazil</td>
<td>BB+</td>
<td>Stable</td>
</tr>
<tr>
<td>Chile</td>
<td>AA</td>
<td>Stable</td>
</tr>
<tr>
<td>China</td>
<td>BBB</td>
<td>Stable</td>
</tr>
<tr>
<td>Colombia</td>
<td>BBB</td>
<td>Negative</td>
</tr>
<tr>
<td>Egypt</td>
<td>BBB+</td>
<td>Negative</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>AA–</td>
<td>Stable</td>
</tr>
<tr>
<td>India</td>
<td>BBB</td>
<td>Negative</td>
</tr>
<tr>
<td>Indonesia</td>
<td>B–</td>
<td>Stable</td>
</tr>
<tr>
<td>Malaysia</td>
<td>A</td>
<td>Stable</td>
</tr>
<tr>
<td>Mexico</td>
<td>BBB+</td>
<td>Positive</td>
</tr>
<tr>
<td>Pakistan</td>
<td>B+</td>
<td>Stable</td>
</tr>
<tr>
<td>Peru</td>
<td>BB+</td>
<td>Stable</td>
</tr>
<tr>
<td>Philippines</td>
<td>BBB+</td>
<td>Negative</td>
</tr>
<tr>
<td>Poland</td>
<td>A+</td>
<td>Stable</td>
</tr>
<tr>
<td>Qatar</td>
<td>A–</td>
<td>Positive</td>
</tr>
<tr>
<td>Russia</td>
<td>B</td>
<td>Positive</td>
</tr>
<tr>
<td>Singapore</td>
<td>AAA</td>
<td>Stable</td>
</tr>
<tr>
<td>South Africa</td>
<td>A–</td>
<td>Stable</td>
</tr>
<tr>
<td>Taiwan</td>
<td>AA</td>
<td>Negative</td>
</tr>
<tr>
<td>Thailand</td>
<td>A–</td>
<td>Stable</td>
</tr>
<tr>
<td>Turkey</td>
<td>B–</td>
<td>Negative</td>
</tr>
</tbody>
</table>

Source: Standard & Poor's
Use of country classifications

Both of these approaches can be of use when doing a high level review of potential target countries, but the final analysis will need to be done in more depth and will need to cover the various physical, social, political and economic factors described at the beginning of the chapter.

Clearly, a company looking to set up a domestic retail network will have different criteria for deciding where to invest than a company seeking construction contracts or one looking to set up a manufacturing unit. A high level desk analysis along the lines set out above should provide a short list of possibilities. Further in-depth analysis would be needed to reduce this to a short list. Such analysis would involve more subjective and forward-looking investigations including assessment of potential and consideration of risk issues e.g. probability of political change and the expected rate of GDP growth. This might include a review of the following more subjective, but none the less interesting, indices.

Corruption Perceptions Index (CPI) – this is compiled by Transparency International – a non governmental body dedicated to increasing government accountability and curbing corruption – who produce an index based on a variety of surveys. Countries are scored on a scale from 0 to 10 with 10 being the least corrupt. A sample of countries scores are set out in Table 5.6.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Singapore</td>
<td>9.2</td>
</tr>
<tr>
<td>14</td>
<td>Hong Kong</td>
<td>7.9</td>
</tr>
<tr>
<td>26</td>
<td>Botswana</td>
<td>6.0</td>
</tr>
<tr>
<td>27</td>
<td>Taiwan</td>
<td>5.9</td>
</tr>
<tr>
<td>36</td>
<td>Malaysia</td>
<td>5.0</td>
</tr>
<tr>
<td>38</td>
<td>South Africa</td>
<td>4.8</td>
</tr>
</tbody>
</table>
Economic Freedom Index – this is compiled by the Heritage Foundation – a body committed to ensuring freedom, opportunity and prosperity – through scoring a number of factors which are relevant to economic freedom including trade, the level of government intervention, fiscal burden, degree of regulation, size of the black market, etc. Scores are calculated on a scale from 1 to 5. Degrees of freedom are expressed on a scale from free to repressed. A sample of scores is contained in Table 5.7.

Table 5.6 continued

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>42</td>
<td>South Korea</td>
<td>4.2</td>
</tr>
<tr>
<td>44</td>
<td>Peru</td>
<td>4.1</td>
</tr>
<tr>
<td>51</td>
<td>Mexico</td>
<td>3.7</td>
</tr>
<tr>
<td>54=</td>
<td>Egypt</td>
<td>3.6</td>
</tr>
<tr>
<td>54=</td>
<td>Turkey</td>
<td>3.6</td>
</tr>
<tr>
<td>57</td>
<td>China’</td>
<td>3.5</td>
</tr>
<tr>
<td>59</td>
<td>Ghana</td>
<td>3.4</td>
</tr>
<tr>
<td>61</td>
<td>Thailand</td>
<td>3.2</td>
</tr>
<tr>
<td>65=</td>
<td>Zimbabwe</td>
<td>2.9</td>
</tr>
<tr>
<td>65=</td>
<td>Philippines</td>
<td>2.9</td>
</tr>
<tr>
<td>71</td>
<td>India</td>
<td>2.7</td>
</tr>
<tr>
<td>75</td>
<td>Vietnam</td>
<td>2.6</td>
</tr>
<tr>
<td>79=</td>
<td>Russia</td>
<td>2.3</td>
</tr>
<tr>
<td>79=</td>
<td>Pakistan</td>
<td>2.3</td>
</tr>
<tr>
<td>88</td>
<td>Indonesia</td>
<td>1.9</td>
</tr>
<tr>
<td>90</td>
<td>Nigeria</td>
<td>1.0</td>
</tr>
</tbody>
</table>

Source: Transparency International
<table>
<thead>
<tr>
<th>Classification</th>
<th>Rank</th>
<th>Country</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free</td>
<td>1</td>
<td>Hong Kong</td>
<td>1.30</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>Singapore</td>
<td>1.55</td>
</tr>
<tr>
<td>Mostly free</td>
<td>13</td>
<td>Chile</td>
<td>2.00</td>
</tr>
<tr>
<td></td>
<td>14=</td>
<td>UAE</td>
<td>2.05</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>Taiwan</td>
<td>2.10</td>
</tr>
<tr>
<td></td>
<td>27</td>
<td>Thailand</td>
<td>2.20</td>
</tr>
<tr>
<td></td>
<td>39=</td>
<td>Peru</td>
<td>2.50</td>
</tr>
<tr>
<td></td>
<td>48=</td>
<td>Sri Lanka</td>
<td>2.70</td>
</tr>
<tr>
<td></td>
<td>63=</td>
<td>Jordan</td>
<td>2.90</td>
</tr>
<tr>
<td></td>
<td>63=</td>
<td>Turkey</td>
<td>2.90</td>
</tr>
<tr>
<td></td>
<td>68=</td>
<td>Botswana</td>
<td>2.95</td>
</tr>
<tr>
<td></td>
<td>68=</td>
<td>Colombia</td>
<td>2.95</td>
</tr>
<tr>
<td></td>
<td>68=</td>
<td>Mexico</td>
<td>2.95</td>
</tr>
<tr>
<td>Mostly unfree</td>
<td>75=</td>
<td>Malaysia</td>
<td>3.00</td>
</tr>
<tr>
<td></td>
<td>75=</td>
<td>Saudi Arabia</td>
<td>3.00</td>
</tr>
<tr>
<td></td>
<td>81=</td>
<td>Philippines</td>
<td>3.05</td>
</tr>
<tr>
<td></td>
<td>81=</td>
<td>South Africa</td>
<td>3.05</td>
</tr>
<tr>
<td></td>
<td>93=</td>
<td>Brazil</td>
<td>3.25</td>
</tr>
<tr>
<td></td>
<td>97</td>
<td>Nigeria</td>
<td>3.35</td>
</tr>
<tr>
<td></td>
<td>106=</td>
<td>Pakistan</td>
<td>3.45</td>
</tr>
<tr>
<td></td>
<td>114=</td>
<td>China</td>
<td>3.55</td>
</tr>
<tr>
<td></td>
<td>114=</td>
<td>Indonesia</td>
<td>3.55</td>
</tr>
<tr>
<td></td>
<td>120</td>
<td>Egypt</td>
<td>3.60</td>
</tr>
<tr>
<td></td>
<td>127</td>
<td>Russia</td>
<td>3.70</td>
</tr>
<tr>
<td></td>
<td>132</td>
<td>Bangladesh</td>
<td>3.80</td>
</tr>
<tr>
<td></td>
<td>133</td>
<td>India</td>
<td>3.85</td>
</tr>
<tr>
<td>Repressed</td>
<td>144</td>
<td>Vietnam</td>
<td>4.10</td>
</tr>
<tr>
<td></td>
<td>146</td>
<td>Zimbabwe</td>
<td>4.25</td>
</tr>
<tr>
<td></td>
<td>153</td>
<td>Iraq</td>
<td>4.90</td>
</tr>
</tbody>
</table>

Source: The Heritage Foundation
A review of scores over a period of several years can give a good idea of what progress is being made. Some countries, such as Chile, show a steady improvement, others, such as Thailand, have shown improvement reversed in the late nineties, and others, such as Indonesia, have shown substantial volatility.

Grey Area Dynamics™

Another approach is adopted by Merchant International Group which has developed a somewhat different methodology called Grey Area Dynamics™ (GAD). This produces GAD scores, some of which are illustrated in Table 5.8.

<table>
<thead>
<tr>
<th>Country</th>
<th>GAD score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>63</td>
</tr>
<tr>
<td>China</td>
<td>76</td>
</tr>
<tr>
<td>Chile</td>
<td>53</td>
</tr>
<tr>
<td>Colombia</td>
<td>87</td>
</tr>
<tr>
<td>Egypt</td>
<td>62</td>
</tr>
<tr>
<td>India</td>
<td>68.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>88.5</td>
</tr>
<tr>
<td>Kenya</td>
<td>85</td>
</tr>
<tr>
<td>Malaysia</td>
<td>66</td>
</tr>
<tr>
<td>Singapore</td>
<td>31</td>
</tr>
<tr>
<td>Taiwan</td>
<td>56.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>67.5</td>
</tr>
<tr>
<td>Turkey</td>
<td>66.5</td>
</tr>
<tr>
<td>Vietnam</td>
<td>76</td>
</tr>
</tbody>
</table>

Source: Market International Group
These scores are compiled from adding scores given on a scale of 1–10 for each of the following components:

- bureaucracy
- corruption
- counterfeiting
- cultural issues
- legal safeguards
- organized crime
- unfair trade
- unfair competition
- assets security
- extremism.

The premise behind this scoring mechanism is that there are a number of hidden factors which will impact the probability of success and/or the value of the investments made by businesses in emerging markets. If management have greater awareness of these factors then they will be better placed to deal with them. Historically, however, managers have been ignorant of these factors or, in some cases, simply did not want to know about them e.g. the need to pay “fees” to get transactions processed, goods released from customs, etc.

Summary

This section has covered a variety of measures that can be used to try and understand the nature of the market you are thinking of entering, or help in the initial screening of possible targets, or to understand the changing nature of those markets you are already operating in. They each cover different angles so using a number of them will help build up a more comprehensive view, especially when the less traditional measures such as the Corruption Index and the GAD scores are factored in alongside more traditional sources of information such as the rating agencies. These measures are particularly useful for understanding potential “extra” costs and in setting target levels of pricing to cover for
Now let us look at some of the changes that have been occurring in emerging markets in the past few years.

**Recent developments**

Over the past ten years or so there have been a number of developments that have changed the characteristics of emerging markets. There is much more talk of and interest in emerging markets these days so how has this come about?

**Positive developments**

The characteristics listed above may suggest a negative picture but there have been various positive developments in recent decades, particularly in the past five years. Consider the following:

- there are some benevolent leaders who have been able to improve their economies despite operating in a one party state, we have already mentioned Singapore;
- it is not uncommon for emerging markets to have high savings rates which can support high investment levels;
- some economies have been able to "jump a generation" – mobile phone networks are being built in countries where physical and economic barriers make development of a fixed line network difficult;
emerging markets can become involved in new industries because of technology and competitive advantages – India is now a global software player;

peaceful transition from one generation of ruler to another does occur – Jordan;

economies do well when commodities prices are high, especially oil prices (though using such windfalls wisely can be problematic);

there is a growing middle class in many countries which increases demand for goods which can boost development e.g. motorcars;

most countries have opened up to trade and market forces even where they have retained strongly centralized political controls – China, Vietnam;

there have been increased levels of regional co-operation and the development of free trade zones, albeit not without many political wrangles e.g. the North America Free Trade Area (NAFTA).

Two factors in particular have spurred development.

**Political change** – more countries now use a democratic process to determine leadership than was the case ten years ago. It is true, however, that this has not worked perfectly in a number of countries, as the old leadership has sought to retain power by fair means or foul e.g. by not allowing opposition parties access to the media, use of physical force or intimidation, freezing development funds for areas with opposition representation and so on. In some cases, the ruling party has simply refused to accept the results of elections and retained power by force.

While the transition from one party rule to full democracy has rarely been smooth, and in many countries remains incomplete, a positive trend is clear and there are some success stories such as Chile and a number of Eastern European countries.

**Economic liberalization** – most governments in emerging markets have recognized that opening up their economies is an important pre-condition for improving their long term growth prospects. This includes some or all of the following:

- deregulation of interest and exchange rates;
- dismantling exchange controls;
- reducing tariff and other barriers to trade;
- permitting foreign ownership of local businesses, including sensitive industries such as financial services and telecommunications;
- allowing more freedom in use of foreign labour.

In part, this has coincided with a change in attitude to foreign inward investment. In the post colonial era many countries were against inward investments of this kind, characterizing it as economic rather than political colonialism, or neo-colonialism. This attitude meant that inward investments were limited, due to one or all of the following:

- prohibition on all forms of investment
- bureaucratic approval processes
- insistence on transfer of technology
- requirements to have local partners or majority local ownership
- controls on repatriation of profits
- limits on the number of foreign workers who had to be replaced by locals within set time-frames.

These factors reduced the potential for economic development. Those countries that always had an open stance on these issues, such as Hong Kong, developed much faster at the expense of others (it is not a coincidence that Hong Kong and Singapore are rated 1 and 2 in the table of economic freedom).

Today, most governments are open about their desire to attract inward investors and in many cases offer incentives such as tax breaks, infrastructure developments, investment grants and so on. They now want more value added to be created at source e.g. exports of oil products has more value than simply shipping crude. The problem generally is that some of the physical and other characteristics described above, as well as competitive factors, sometimes limit the development opportunities in various emerging markets. Sometimes projects start off with good intent but relations sour, which then impacts on other potential investors. The following case study illustrates this point quite well.
In the early nineties, India started opening up and Enron, a US company based in Texas, was one of the pioneering investors. It was contracted to build a power plant in the Western State of Maharastra at Dadabhol. The plant started producing power in 1996, but the project has been dogged with problems throughout, many caused by political factors. Reputational damage has been caused to India due, for example, to there being a forced renegotiation of the contract terms after it was signed and claims that Enron bribed officials to obtain the contract. At one stage the state government was defeated in an election due to the unpopularity of the project. Today financial difficulties are hitting the headlines because the purchaser of the electricity produced (Maharastra State Electricity Board – MESB) has not paid for electricity taken.

The underlying problems reflect some of the points detailed above:

- users do not pay a price for electricity that reflects costs of production (subsidized markets);
- much electricity is lost due to theft or leakage;
- electricity is controlled by a state run bureaucracy (lack of effective deregulation).

In addition to these more generic problems the project itself has problems including:

- MESB must pay high fixed rate charges whatever the level of output;
- the plant was designed to run off naptha and raw material prices have risen sharply;
- sale of electricity to third parties is not permitted.

Changes are required to resolve the issues to the satisfaction of both parties, especially as a second plant is currently being built, but it is not clear how this is going to be achieved to mutual satisfaction.

Enron may not lose financially, as MESB is guaranteed by the Indian government, but it would not be surprising if Enron lost interest in investing in emerging markets as a result. More importantly for India, failure to settle will lead to further reputational damage which could turn off investors already wary of investing in the country. The lengthy dispute already seems to be having this effect.
We can surmise from the foregoing commentary that much progress has been made, but that sometimes the road is rather rocky. Change is also happening in the developed world, however.

**Push or pull?**

There is much that emerging markets can do and are doing to make themselves more attractive to investors from the developed world. In some cases local markets have become broader and deeper e.g. middle class income earners in India. Other countries have been seen as good staging posts to supply regional markets e.g. Thailand. These are “pull” factors but there are also “push” factors at work which have encouraged companies to look outwards from their home markets and production bases. The two main ones are:

*Maturity in developed markets* – companies generally start small and grow through expansion in their domestic markets. Eventually the potential to grow, even in large markets such as the US, reduces once a company achieves national coverage and builds a significant market share. In some cases regulatory factors or changing tastes affect market demand – smoking for example. Once this point is reached it is more or less inevitable that companies will seek to expand overseas. Initially this is done in developed economies but as they reach saturation the only room for expansion would appear to be emerging economies.

*High costs of manufacturing* – costs of production have risen to high levels in most developed countries as labour costs, in particular, have increased due to skill shortages, trade union pressures and government regulations. It is not surprising, therefore, that companies are looking to reduce their costs by manufacturing elsewhere.

The above two factors are the two sides of the profit equation, higher sales and reduced costs increase profits. A significant push factor here is the desire to meet market expectations for listed companies. The market expects regular growth in quarterly profits. The reward for achieving that is a higher share price which provides incentives for senior management whose remuneration packages include share options and bonuses related to financial performance. The risk is that this focuses management on short term revenue growth and cost cutting rather than longer term growth – the revenue/risk culture conflict that we explored in Chapter 4.
Facilitators

In addition to the push and pull factors described above there have been other changes which have facilitated the growth in investment in emerging markets. By facilitators we mean factors which have made it easier to realize plans, factors without which certain developments would not have been possible.

The main ones are:

Technology – developments in computing power in the past 10–20 years have been astounding – desktop PCs have more power today than room sized mainframes 20 years ago, for example. This computing power has driven many changes, some not immediately apparent. Many production processes are now computer controlled, aircraft can take off and land unaided, many decisions on the provision of credit facilities are no longer made manually, and so on.

Apart from computing there have been many developments in materials and production methods which have impacted on what can be made and how it is done. Technology has allowed smaller production units to be developed which can be more economically set up in emerging markets, such as mini steel mills or smaller scale electricity generating units.

Communications – advances in telecommunications and reductions in communication costs have helped to effectively shrink the world – teleconferences are now commonplace as is the use of faxes, e-mail, courier companies and mobile phones.

Transportation – developments in this field have been as important if not as dramatic. Increases in the size of planes, the number of airlines and the number of destinations has spawned a steady rise in the number of people travelling and the volume of cargo. In particular, the numbers travelling long distances has increased more than proportionately as people want to go to further afield on business and for their holidays.

Without these developments in technology, communications and transportation we would not have the Internet and e-mail, nor would we have new business models which are no longer tied down to specific locations or even countries. Call centres can be set up virtually anywhere, small businesses suddenly have global reach and work can be sent from the US to a software developer in Asia overnight and returned by the opening of busi-
ness the next day. All of these developments are helping open up emerging markets to the world economy.

Another factor of some importance that is having the same impact has been a change in economic models. The traditional production model, from the days of Henry Ford onwards, has been one based on vertical integration. The premise for this is that if you own all stages of the production cycle then you have more assured supplies, can control quality and produce economies of scale and thus increase reliability and profitability. This approach led to the building up of very large companies with interests stretching from the conversion of raw materials to intermediate goods, production of consumer goods, through to sales, financing and after sales services. Over time it has been realized that this model has a number of limitations, the prime ones being:

- a lack of flexibility
- vulnerability to downturn in sales volumes
- the need for a wide range of skills.

For example, if a subsidiary company sells 100 per cent of its output to its parent it will suffer if demand drops and it is not allowed to sell its product to third parties. The antidote to this has been for companies to move to a model based on outsourcing. Let us reconsider the Nike story first introduced in Chapter 2.

**Look – no factories**

Nike’s original business was selling sports shoes. It grew rapidly in the late eighties and early nineties as it managed to convince buyers, particularly the teenage market, that sports shoes (trainers) were fashion accessories.

In a traditional model Nike’s growth would have been constrained by the level of production capacity it owned, but this was not the case because Nike’s business plan was to concentrate on its core competencies which it saw as product design and marketing. Production was therefore outsourced to wherever it could obtain the quality and quantity of goods it wanted. With growing costs in the US most of these production units were located in Asian countries such as Thailand, Indonesia, China and Taiwan where costs were much cheaper.
The benefits of this model were that as sales grew Nike could meet demand by raising the volume of orders to existing suppliers and taking on new suppliers. It also allowed them the flexibility to move orders to the cheapest suppliers. For the suppliers in emerging markets this helped them to grow and make profits, but has left them vulnerable to a downturn in orders and the rise of new suppliers who could undercut them. Both of these things happened as the volume of trainer sales peaked and then fell and countries such as Vietnam set up new factories. The risk to Nike has always been that goods do not arrive on time or fail to meet its quality standards. For producers, the risk is will they get enough orders to keep their factories fully operational?

Over time the model has allowed Nike to expand their product range beyond simply trainers into sports and fashion clothing, and most recently into golf balls, as all it needs to do is find suppliers with the requisite skills, capacity and quality.

Nike is by no means uncommon. Its competitors, Reebok and Adidas, work off the same model as do most of the major well known fashion brands such as Tommy Hilfiger, Calvin Klein, Gap, etc.

In Nike’s case it never had any factories but many other companies which did are also changing. In the eighties and nineties Japanese manufacturers set up many subsidiaries and joint ventures in emerging markets to manufacture components or assemble cars, electronic goods, etc, as the costs of production in Japan became so high. Now they are, in some cases, selling these off to management or specialist outsourcing companies who are looking to manufacture pretty much anything for anybody.

A different production model that Japanese companies are well known for is just-in-time. This model works on the basis that companies hold little or no stock but order it as and when needed. This latter model requires its suppliers to be located close by and in constant communication and to have rigorous quality standards. Needless to say this brings benefits in terms of costs but adds new risks.

These two developments have spawned substantial industrial complexes in several emerging markets which have helped raise income levels in those regions significantly. Consider Penang.
It is not all good news, however, as these developments sometimes lead to over concentration. As the US economy has slowed and the spend on technology by businesses and consumers has dropped sharply, areas such as Penang are being affected badly. Overall, however, the Asian economies are better placed today than they were in 1998 to absorb the impact of a downturn. This is because they are less dependent on fixed or quasi fixed exchange rate systems, they have much larger foreign exchange reserves, and some structural changes have been made, albeit not as many as people would like.

**Investment patterns**

Emerging markets are many and varied. Some are attractive to investors, others are less so. The reality in the past decade or so is that there have been relatively few countries which have seen the bulk of inward investment. Many investors have seen the biggest potential to be in China and this has “pulled” in huge investments albeit this is somewhat distorted by factories relocating from Hong Kong, in 1999 for instance it attracted over USD30 billion of investments to India’s 2.2 billion.
To move up the “investment league”, countries need to make themselves more attractive to investors. This is not impossible, as countries such as Chile have proven, but as we have explained earlier it usually requires competitive advantage and judicious economic management to do this. The higher the degree of instability the harder it will be. India, for example, has huge potential but investors have increasingly become disillusioned and moved projects elsewhere due to delays or other obstacles. The Enron dispute will not help.

**Less favourable developments**

The previous section has highlighted a number of developments which have helped make emerging markets more attractive places to invest in, either as markets in themselves or as places to serve regional or global markets. These developments have not all been positive as has been illustrated by the various country specific crises which have had regional or global repercussions. The Asian crisis, in particular, has highlighted a number of underlying structural problems which were not so evident during the eight to ten years when most countries saw growth rates averaging between 5 and 10 per cent. These include:

- lack of transparency
- protectionism
- international standards not in use e.g. accounting
- inadequate laws e.g. to deal with bankruptcy
- lack of independence, of the central bank for instance
- nationalism – unwilling to forgo ownership of national airlines or utilities
- changing the rules e.g. Malaysia imposing exchange controls
- political interference.

The current concern is that most Asian countries have had a short lived rather than a prolonged downturn. This has reduced incentives to continue reforms. The problem is that the upturn in these Asian economies was largely export led driven by improved competitiveness resulting from substantial devaluation against the dollar and other major currencies. Domestic demand remains weak and with a slow down occurring in the US, growth rates are going to slip again which will bring these structural problems to the fore once more. Specific concerns are:
• governments have taken over large parts of the economy, particularly in the financial sector, but have not been able to divest themselves of them quickly or without problems;

• government finances remain weak so their ability to help is limited. Those that have not lived up to the commitments to the IMF are unlikely to receive renewed support;

• concerns over uncertainties have led investors in capital markets to withdraw, resulting in a net outflow of funds in the past two to three years. Long term investors are wanted but neither they nor the short term investors will return while local demand remains weak and uncertainties persist. Very few companies can now tap international capital markets;

• the local financial sectors remain weak. Local banks are unable to lend and foreign banks are unwilling to lend until there is more stability and greater transparency;

• nationalistic sentiments remain strong. Some foreign investors have been wary and backed away, or those who have actually invested have had problems e.g. adverse press or demonstrations;

• political uncertainties remain or have resurfaced – we have mentioned Indonesia, Turkey and Zimbabwe but there is also uncertainty in the Philippines, Peru and India, to name but a few.

Long term commitment to reforms are needed to address these issues but, as we have illustrated at the beginning of this chapter, there are often physical, economic, social or political limitations which need to be overcome.

Conclusion

Emerging markets is a term that is in common usage today but it is one which is rarely defined and means different things to different people. It covers a very broad range of countries which exhibit some of a variety of physical, economic, social or political characteristics which have, so far, inhibited them from reaching developed status. Lack of development and/or instability are the key characteristics which distinguish emerging markets. Some of the
underlying factors are hard to change, others are self inflicted. Improvement has occurred in many countries in the past ten years or so, not least because of political change and economic liberalization.

Today, there is a greater acceptance that there is a need to open up to increase income levels and that in doing so, reforms must occur. This includes a willingness to accept more investment by foreign companies and/or ownership of local companies. Those countries which are most willing to go down this road will have the greatest prospect for improvement in the 21st century. Though the potential rewards may be high for companies looking to invest in these markets this will only come to those that understand and manage risks effectively.

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**Summary**

- Emerging markets are defined as:
  
  *those countries which have started to grow but have yet to reach a mature stage of development and where there is significant potential for economic or political instability.*

- This definition covers a broad range of countries but excludes those which are at the bottom of the development prospect list.

- There is no typical emerging market but they have a variety of characteristics in common which, one way or another, make them weak or vulnerable to internal or external shocks.

- Given this large number of countries it is useful to group them together or rank them using a variety of methodologies depending on the purpose.

- Despite their various weaknesses that emerging markets exhibit, there has been progress in a number of areas in the past 10 to 20 years.

- Improvements have resulted from changes internally, particularly attitudes to outside investors, but also due to markets maturing in developed countries and costs of production rising.

- Pull and push factors have combined to increase the level of interest in emerging markets as target markets as well as production bases.

- This increased level of interest has been facilitated by technology, communication and transportation improvements.
• The Asian crisis, amongst others, has highlighted the degree to which fundamental change has, or has not, happened in the various markets. It has helped accelerate some positive developments, but the pressure has been reduced recently, which gives cause for concern.

• There is now general recognition that inward investment is a key to increased growth and that to attract investment change is needed.

• To investors this is good news but apparent high levels of rewards only come with higher levels of risk. Understanding those risks up front is necessary to avoid expensive mistakes.

References

CHAPTER 6
Culture and language

“Culture is like gravity: you do not experience it until you jump six feet into the air.”
FONS TROMPENAARS

Introduction

In Chapter 5 we have defined emerging markets and considered their key characteristics and recent developments in some detail. There are two aspects that it is worth exploring in more detail – culture and language – because without an understanding of both these factors it will not be possible to manage risk effectively in emerging markets.

This is necessary because, as we have indicated in Chapter 4, culture is a key driver of behaviour. Given the diversity of cultures found in emerging markets we need to understand what behaviours we can expect in such countries when faced with similar situations. In some cultures, for instance, it is not considered polite to contradict the boss or tell him (or her) bad news, so information about risk issues or things not going well may not get passed up the line until it is too late. If you then find out about something, unexpected risks say, how are you going to handle the situation – rant and rave? This may cause loss of face and have serious repercussions for the individual berated, yourself, and/or your whole team. The best results will be
obtained from a clear understanding of the culture in which you are operating and dealing with it in an appropriate manner.

Historically this is not how things have been handled, but the world has changed. During the earlier parts of the 20th century, for instance, when many emerging markets were run by colonial powers, a small group of foreign managers ruled large numbers of people with little effort. They could do this because they had hierarchical control systems and strong rule of law backed up by military power. Today things are different. In the post colonial world, foreign managers are guests not rulers. They must understand and acquiesce to get things done, not shout louder until action is taken. They must negotiate to achieve what is required. Effective negotiation requires an understanding of the culture they are dealing with, as well as their own culture, and being able to communicate across the divide. As woodworkers know, it is much easier to work with the grain than against it.

Through understanding cultural issues, and communicating effectively, it will be possible to achieve one’s goals by engendering the right behaviours in the people you are managing or working with. Without it, success is unlikely and you may not even know why.

Culture

This is not the right place to delve deeply into the subject of culture, but it is important to cover some of the basics as this will help us understand the key issues in managing risk in emerging markets in the next chapter. To explore these issues in more depth it is recommended that you read the various works of Fons Trompenaars, Charles Hampden-Turner and Terrence Deal and Allen Kennedy, referenced at the end of the chapter. Much of this chapter is based on their ideas.

Firstly, what is culture?

What is culture?

There are a variety of definitions but one of the most useful for our purposes is that given by Fons Trompenaars which is:

\[
\text{culture is the way a group of people solves problems.}
\]

In our business and personal lives we face many problems each and every day. How we deal with those problems will be influenced by culture. If
someone is late for work do we simply shout at them or try and find out if there is a problem at home? If there is a problem, do we expect them to sort it out and not bring it to work or are we sympathetic and try and help them? If there is a problem in our daily work do we deal with it and tell the boss later or simply pass the buck? If we know we do not have authority to make a decision, but taking time referring upwards would cost the company more, do we make the decision and take the responsibility? If you do, does your boss blame you when he finds out you have exceeded your authority, even if it was with good intent and saved money?

All these responses will be conditioned by our culture. Culture drives behaviour. It is something we learn, not something we are born with. How we are treated by our parents, teachers, peers, work colleagues, bosses, etc, will influence how we think and behave. Take the above example. If we do something without authority but our boss chastises us, even if it was the right decision, how are we going to behave next time? If we are sensible, we will do it the way the boss wants – refer upwards. His actions will have influenced our behaviour. We will have been conditioned the same way as we will have been conditioned by our parents to understand the difference between right and wrong, the need to have respect for elders, etc.

**Types of culture**

Unfortunately, we cannot simply say what culture we have, as it is not one-dimensional. While where we live or were brought up are strong influences, simply looking at our nationality, place of residence or the organizations we belong to is not sufficient to help us define someone’s culture.

Culture is complex because there are a wide range of factors which determine it. We can think of these as levels of cultural influence. They include the following:

- **nation** – Britain, China, India
- **region** – East or West Coast USA, North or South India
- **company** – IBM, Microsoft, McDonald’s, GE, San Miguel
- **profession** – lawyers, teachers, bankers
- **society** – Masons, the Scout Movement, Salvation Army, sports clubs
- **religion** – Christians, Buddhists, Muslims
- **family** – nuclear, extended, disparate.
In practice there will be a number of cultural influences working on us at the same time. These influences will be stronger or weaker depending on where we are or what we are doing. At work the corporate culture may have more influence but at home, the family is likely to be more important. In some societies, Western ones in particular, the corporate culture will be left at work but elsewhere this is not so e.g. where the company provides accommodation, schooling and other benefits to its workers.

The relative strengths of the various cultural influences and how they overlap and interact differ between countries. These factors can be more pronounced in emerging markets. What is important therefore, from the business perspective, is to understand how these various cultural influences operate and how they will impact on the behaviour of people within their corporate lives. In particular, we need to understand where there are significant differences between the culture of the people we are working with in emerging markets and our own culture. To do this we need to understand what influences culture.

**Nature of culture**

A useful model which can be used to explain culture is that developed by Fons Trompenaars which envisages three concentric layers.

*Outer layer: explicit products* – this is the most obvious representation of culture, the things that we see. How people dress, the nature of their buildings, how they speak and act, and so on. These are the visible signs, the ones we use to judge people.

*The middle layer: norms and values* – the norms and values of the various cultures underlie observable factors:

- Norms – these define what is right or wrong for the group. They may be explicitly written down as formal rules or laws, or may simply operate at an informal level. Business dress is a good example. What we wear to work can vary from formal business suit, white shirt only and no loud ties, through to casual dress. What is acceptable may be defined by head office rules or simply precedent. As individuals we generally feel more comfortable when we do not stick out from the crowd so we will dress as others do.
Values – these are more aspirational. How do I desire to behave rather than how do I behave.

A stronger culture will develop where norms and values are aligned. If, for example, one of our values is that we encourage risk taking but the norm is to seek someone to blame when something goes wrong, there is conflict. The inevitable result is that people will be discouraged from taking risks. Similarly, parents try to engender in their children the value that hard work is necessary to achieve results. If, however, they go to a school where the norm is to do the minimum of work and hard workers are classed as swots, norms and values conflict. It will not be surprising, therefore, if children work less hard if they want to be accepted by their peers but pretend to their parents that they are working hard – as they will want to keep both groups of people happy.

The core: assumptions about existence – the basic challenge for people has been survival. How different groups have organized themselves to deal with the environment that they live in is at the core of culture. Nomadic tribes wandering the desert, groups living in icy wastelands, agricultural settlers, etc, have all had to deal with the basic needs of finding shelter and food, giving birth and dealing with death and so on. In doing so, quite diverse cultures have developed. These diverse cultures have been influenced by things such as whether peoples were settled or nomadic, did they need strong leadership and teamwork or could they work as individuals, were they threatened and needed to fight or was the environment peaceful, etc. Over time, observable aspects of these diverse cultures developed such as language, firstly spoken and only much later in written form, as well as the development of art and architecture, rites and rituals, dress, etc. These are the explicit products of the culture, but alongside these the values and norms will have developed and they may be quite different from what we are used to. Killing people and making sacrifices may, for example, be acceptable in some cultures but would not be in most.

If we think then of the history of the various peoples across the world and use Trompenaars model, we can see how cultures have developed from the centre outwards from basic assumptions through norms and values to the outward manifestations of that culture. This has occurred over thousands of years. Organizational cultures are a much newer phenomenon so it is not surprising that national cultures are usually
stronger than organizational cultures nor that, given that the nature of emerging markets is different from that of the developed world, that cultures in emerging markets can be quite different from those in developed markets.

What is the nature of those differences?

**Cultural dimensions**

Based on extensive data collected over a number of years and anecdotal evidence, Fons Trompenaars has suggested a number of areas where there are distinct national differences that help determine national cultures. These are:

*Rigid or flexible* – when faced with a situation do we always apply the rules or do we allow flexibility dependent on circumstances or obligations e.g. would family obligations pressure us to overlook company rules?

*Individual or group* – which is more important “looking after number 1” or ensuring the best for the group?

*Objective or emotional* – do we look at things in a purely objective or detached manner? Can we freely express our emotions?

*Relationship or contractual* – do we build a relationship with people and then do business, or are we interested in business first and developing relationship afterwards?

*Merit or position* – do we value what people have done, or their background and connections more?

*Past, present or future* – which is more important yesterday, today or tomorrow and how do they influence our actions?

*Influence or influenced* – do we think we can influence the external environment or is it a given that we must deal with?

Each of these dimensions will influence to a greater or lesser extent the type of culture which is prevalent in various countries. Table 6.1 suggests how American and Asian cultures differ in these respects. Needless to say this is an oversimplification but it does illustrate how divergent various
cultures might be, which reinforces the importance of understanding these issues to be able to effectively manage across cultures.

Table 6.1 Dimensions of culture

<table>
<thead>
<tr>
<th>Dimension</th>
<th>American</th>
<th>Asian</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rigidity</td>
<td>Following the rules tends to</td>
<td>Flexibility is likely to be</td>
</tr>
<tr>
<td></td>
<td>be more important.</td>
<td>accorded depending on circumstance, relationships or obligations.</td>
</tr>
<tr>
<td>Individualism</td>
<td>Primarily individually focussed.</td>
<td>The group may have more importance than the individual, especially family.</td>
</tr>
<tr>
<td>Objectivity</td>
<td>Emotions often avoided.</td>
<td>Emotion may be important but will rarely be openly expressed.</td>
</tr>
<tr>
<td>Relationship</td>
<td>Focus on the task first.</td>
<td>Doing business usually starts with building relationships.</td>
</tr>
<tr>
<td></td>
<td>Relationships may follow but</td>
<td>Handshake seen as important as a formal contract.</td>
</tr>
<tr>
<td></td>
<td>are not essential.</td>
<td></td>
</tr>
<tr>
<td>Merit</td>
<td>Promotion should be based on</td>
<td>Family, school and other connections of prime importance.</td>
</tr>
<tr>
<td></td>
<td>results.</td>
<td></td>
</tr>
<tr>
<td>Time</td>
<td>Forward looking. Much less</td>
<td>More equal balance between past, present and future orientations.</td>
</tr>
<tr>
<td></td>
<td>focus on the present or the</td>
<td></td>
</tr>
<tr>
<td></td>
<td>past.</td>
<td></td>
</tr>
<tr>
<td>Influence</td>
<td>Believe the environment can</td>
<td>More fatalistic.</td>
</tr>
<tr>
<td></td>
<td>be changed.</td>
<td></td>
</tr>
</tbody>
</table>

Source: based on Fons Trompenaars, *Riding The Waves of Culture*
No one culture

Any description of a culture will only be a generalization, as not all people within a country will conform to a national stereotype. Not all Americans, for example, are rigid, unemotional, individualistic, task-oriented, forward-looking meritocrats seeking to change the world as the above might suggest. We have indeed already indicated that East and West Coast Americans have different cultures. The East Coast is more business and task-oriented, while the West Coast is more laissez-faire. Similarly, in Asia there are significant differences in cultures between and within the various Asian countries. In addition, some countries, for example Singapore and Malaysia, may be classed as multiracial, making it important to understand not one but several cultures.

One way to look at this is to think of it as a normal distribution. A description of a national culture should correspond to characteristics of the majority of the people – the part within one standard deviation of the mean of a normal distribution. As we move away from the mean, people will increasingly diverge from the stereotype but there will be fewer and fewer of them.

What we have to appreciate, however, is that national stereotypes are breaking down as more and more people move around. In the US, for example, the proportions of white, black and Hispanic populations, which each have distinctive cultures, are changing both nationally and regionally. Within certain cities, the proportions of people from each of these groups has changed over time, producing significant change in the culture of those cities or parts of them. At national level, this is not yet as profound an influence, but it is only a matter of time. In emerging markets, changes are also occurring. Such changes are being driven by the movement of people from the land into cities, ongoing tribal or religious conflicts, the building of new industrial business centres, and other economic developments.

Let us now consider culture at a business level.

Business cultures

We have said that culture drives behaviour. At a business level we are concerned with ensuring that we engender behaviours which will produce the results we desire – sustainable growth in profits with low volatility. Achieving this requires the right strategy and adequate resources but also an appropriate and strong culture. Applying Trompenaars’ model, described above, to the business context the cultural issues are as follows.
Assumptions about existence – the fundamental requirement for a business, like us as individuals, is survival first and then, hopefully, prosperity. The culture of a business will be strongly influenced by, for example, whether it is a new start up in a competitive environment, or a protected monopoly. In emerging markets, an argument is usually made that local businesses need to be protected behind tariff barriers to develop. As pressures build up to reduce those barriers, companies are concerned that they will be unable to survive. In part this will be due to the need to change the company culture to deal with a different environment. Consider how well former national utilities have fared once they have been privatized and markets deregulated, or how most state run enterprises in the former communist states have struggled in the capitalist world.

Norms and values – companies with a strong culture usually have clear and well known values and norms, often driven by the values of the founding father of the business. Wal-Mart is a good example of a company with strong values based on those set down by the founder Sam Walton. In Asia, companies such as Giordano have a strong culture based on customer focus and rewarding staff well.

Explicit products – the outward signs of culture are well developed in many companies – corporate signage, well recognized colour schemes, office or retail layouts, uniforms, advertising slogans and so on. Many of these signs are instantly recognizable – the McDonald’s Golden Arches, for instance.

Taking this model further we can see how senior management and the board influence corporate culture by:

- choosing the playing field in which the company will operate;
- setting down the values of the company;
- reinforcing values with actions which then define and reinforce norms;
- and enhancing the explicit products of the culture.

A strong culture will develop where there is clarity and consistency between all these levels. Deal and Kennedy expand on this in their book Corporate Cultures (1982) with many illustrations of how strong cultures have been built up in household names such as Procter & Gamble, IBM, GE, etc, and describe how “rites and rituals” are used to reinforce those cultures, perpetuated by “heroes”. Equally they show how managers, who
say one thing and do another, quickly undermine any initiatives to build a strong culture. Like reputations, cultures take a long time to develop but can be destroyed very quickly.

We must not forget that, much the same as countries, there is more than just one company wide cultural stereotype, and that the described culture will not fit with all the people in an organization. Each of the main areas within a business are likely to have different cultures – sales, production, finance, etc. In many organizations, there may be conflicts between these areas. Risk managers, for example, will have their own culture that is likely to come into conflict with other areas of the organization. A reason for these different cultures is that each part of the organization is looking to do its part to achieve organizational goals. Risk managers often see their role as avoiding loss, rather than achieving profits, which will conflict with the sales manager who wants to hit his sales targets. Goals and measures of success for each of these areas need to be closely aligned to develop and sustain a strong culture, particularly across a large organization.

**Drivers of behaviour**

As we said, culture is a driver of behaviour but it is not the only one. Figure 6.1, a simplification of Fig 4.8, illustrates the other forces at work. Managers know what results they are expected to achieve and are, hopefully, clear about the strategy of the organization to achieve those results. What happens though, if the current opportunities are such that results cannot be achieved due to internal or external factors. What do managers do? This is where culture comes into play – to help solve the problem. Remember our definition of culture?

External reasons for this problem occurring might be:
The market has changed – if this is the case, the strategy should be revisited. In a strong culture, you would expect this information to be fed back to senior management who would consider the strategy or the targets, or both, and take appropriate action. In a weak culture, it is more likely that managers will ignore the strategy and seek to do business which is more risky, inappropriate or at inadequate margins to meet quotas, revenue targets, etc. This type of response is likely where there is a disconnect between what senior managers say and do e.g. they talk values but are only interested in bottom line numbers.

The strategy was wrong – in a strong culture, the strategy would be challenged early on and there would be opportunity to change it. In a weak culture, managers would most likely focus on results and ignore the strategy.

There was no strategy or it was poorly communicated – this is more likely in a weak cultural environment. Managers will manage in accordance with their own interests.

Internal reasons for an inability to achieve results will usually include:

- lack of resources – people, physical assets, time;
- delays of one kind or another – new products not ready, expansion of capacity not on stream, etc.

In such circumstances do managers make do and still strive to achieve results or do they raise the matter with their boss? If they do raise the matter do they get a fair hearing and sympathy, or told to get on with it. Where the problem exists in an emerging market subsidiary in a culture which avoids conflict, you can imagine that problems of this nature will not be fed back to the centre quickly or at all.

Given that cultural issues are going to be different in emerging markets, it becomes clear from this type of model that getting the strategy right in relation to available opportunities is very important as it then lessens the possibility of cultural stresses occurring e.g. knowing something is not going to work in that market but not being able to tell the boss.

National and business cultures

We have looked briefly at some of the issues in relation to national cultures and the factors at work within businesses. It is now important to understand how these two forces interact.
As we have said above, each person within an organization will be subject to a number of cultural influences including national and business cultures. Which has the greatest influence will depend on their relative strengths and circumstances. In the business environment we would expect the business culture to prevail but this will only be the case where there is no conflict with the national culture. This is because national cultures are generally more important to us. This is not surprising given that national cultural traits are something that are programmed into us almost from birth, but business cultures are only “programmed” later in life. Unless we stay in the same organization for all our working life, something which is becoming less likely, we will be subject to a variety of business cultures as we move from organization to organization. Each organizational culture will have less and less influence. Hofstede discusses this difference between national and business cultures in some detail. He sees national cultures as largely representing values while organizational ones represent practices. This is because of the point made above, national values are programmed from early on whereas organizational values are learnt much later. This view is not shared by all, as it suggests that values have less importance in organizational cultures than practices, which are the more visible signs of culture.

In addition to factors which may produce national/business culture conflicts, there may be other strong cultural influences which have the same impact e.g. religion. Muslims will be averse to dealing with certain business activities or practices which are contrary to the values of their religion e.g. handling pork, dealing with interest or gambling. Some Christians will be averse to working on Sundays, etc.

From a management point of view, the important thing is understanding these issues exist so they can be managed effectively. In the same way as risks that are not identified will not be dealt with, failure to understand cultural issues means that they will not be managed. This management failure is likely to lead to problems. In some cases, the problem will be obvious immediately e.g. through protests, strikes, lack of co-operation and silence, but in other cases, workers may simply keep quiet, bide their time and get back at management in subtle ways – sabotage, spreading rumours, saying yes but doing nothing and so on. Consider the following:

Failure to understand cultural issues means that they will not be managed.
Where local management do not agree with the way Head Office wants them to do something they can challenge it or say nothing and carry on doing what they want to do.

The latter route is more likely to occur where the culture is one of non-confrontation. Managers will know they are not doing what they are supposed to but hope they are not found out. If they are, they may well plead ignorance or misunderstanding.

Head Office, of course, would rather be challenged, as at least then they will be aware there is an issue and can deal with it.

Cultures favouring groups over individuals will not respond well to the imposition of an individual, rather than team, performance related pay structure. This should be fairly obvious given that such an approach will cause problems for individuals who do not wish to be seen to benefit at the cost of the group. What is the likely outcome?

In all probability it will fail because people will not co-operate. In a sales environment it is even possible that sales will fall. Sometimes individuals will seek to maximize their income but then redistribute it to the group so that everyone gains.

Whatever happens the change will cause anxiety and consternation, which is likely to distract from performance. If management were aware upfront of these potential cultural problems, they could reconsider their actions. If they go ahead in ignorance, it may well be some time before they find out why expected results do not materialize.
These examples show how cultural clashes can arise through a lack of understanding. Failing to send a senior enough person to a meeting with potential customers can be seen as an insult, as it indicates that the company did not understand the importance of the person being met. This “loss of face” will not be obvious at the meeting, but it may well be the last meeting granted and it is likely business opportunities will not be pursued or existing business will dry up.

This issue is neatly summarized in Richard Lewis’ work where he discusses how cultural interaction can lead to synergy or conflict. How meetings are run in different countries illustrates how this works. US or British managers like meetings to start on time and stick to the agenda. Their priority is to get the deal done, and once done maybe conclude the deal with a social meeting. In other cultures, socialization is more important and people operate to flexible time schedules. If a meeting is scheduled but people turn up late there can be confrontation or adaptation. If there is adaptation, then cultural synergy can develop. If confrontation, a negative situation will develop and achieving a deal will be very difficult. It is how people react to the outward signs, therefore, or the cultural display as Lewis calls it, that is important in determining which result occurs.

Lewis groups cultures into three broad categories which helps us understand more easily where cultural problems might occur. These groups are:

*Linear-actives* – people who are well organized, like schedules and time keeping, and aim to do one thing at a time.

*Multi-actives* – people who are outgoing and talkative, that do not keep to time and do many things at once.

*Reactives* – people who place importance on courtesy and respect, listening attentively and quietly, and reacting to proposals.

Problems in dealing with meetings, such as those described above, are more likely to occur where there are linear-actives on one side and multi-actives on the other. This and other issues are well covered in Lewis’s book.

We have said we need to be careful of cultural stereotyping. In addition, we need to be aware that things are changing. These changes are placing a strain on traditional cultures making it more difficult to predict how people are going to behave.
Cultural change

Culture builds up over a long period of time. It will be perpetuated over a long time-frame only if there is a stable environment and it is strong enough to resist outside influences. Many emerging markets remained virtually closed societies for a long time – Turkey, China, Eastern European states, etc. Physical movement of peoples and goods were controlled, exchange controls were in place and news of the outside world was limited. As such they were able to protect their cultures but economic development was stifled. In order to develop they have opened up while technological developments have meant that access to information cannot be controlled very easily any more. Some changes that are happening are:

- there is more exchange of people between emerging and developed markets;
- the Internet and satellite TV has exposed people to world news and lifestyles;
- more people are being educated in Western universities;
- trade levels are rising as barriers are lowered;
- companies are setting up in emerging markets or acquiring companies, bringing new technology and business techniques.

The result is that people in emerging markets are more aware of Western products, other languages and customs, different ways of dress, and lifestyles that they often find attractive. This is challenging traditional values. Consider the following.

Youth is youth

Cultural challenges are more evident amongst the young. Teenagers today in many countries dress similarly, listen to the same music, go to discos, drink and smoke, want the latest fashions and PC games, and use mobile phones actively. They read the same magazines, travel more and scan the internet for the latest trends or pick it up from Western programmes on satellite TV or other broadcasters.

The result is that they may well clash with their parents, or more likely grandparents, who hold more traditional values. This is particularly so in hierarchical societies, or those where religion plays a big part in life.

This is not to suggest that all youths are rebels, but that there are clear trends evident which are likely to continue and expand globally.
A slighter older group of people are also creating cultural waves.

**Conflicting influences**

In emerging markets it is increasingly common for the most talented people to study abroad for their first or second degrees – the US, the UK or Australia being particular favourites.

A number of years studying in these countries exposes them to Western cultures much more deeply than watching Western TV shows. In some cases the cultural changes are significant – young female Muslims are suddenly free to go where they want, converse with single males without a chaperone and dress as they wish. How do they react and feel when they go back to a more restrictive environment?

In the business world they generally find employment relatively easily, particularly in tight labour markets. Companies owned, run by or trading with international companies find such Western educated people attractive employees, given the expectation that they are able to bridge the gap between local and Western cultures.

For the individuals involved, they may have difficulty in dealing with the conflicts between their national culture and that of their place of education. This may create problems and conflicts both at home and in the office.

These influences on the younger element of the population are leading to cultural change. They have higher aspirations in terms of their standard of living and are less tolerant than older generations, which threatens family and national cultural values. This is hardly surprising when people return from three to four years of freedom from parental control and are expected to go back to living at home, where coming home at 2 am is frowned upon or actively discouraged. Another problem for these well-educated people is that development has not proceeded quickly enough in some countries to create sufficient jobs for them, leading to frustration and social problems. With many emerging markets having a high proportion of people under 15 this problem may only get worse which will create or stoke up existing social and political tensions. One unfortunate consequence of these frustrations is that the most talented people either do not
return home or return home but leave shortly after for more developed countries where they perceive they have better job and lifestyle opportunities. This so-called “brain drain” is of particular concern for those emerging markets with a limited pool of talent.

The Asian crisis and similar events illustrate another trend that has also caused tension – increased foreign ownership of local companies. Where companies have gone bankrupt or have significantly weakened financially they can often only be saved through acquisition by the state or sale to foreign companies. State ownership is no longer the favoured solution, other than in the short term, and may be beyond government means. For some people there are tangible benefits of foreign take-overs such as:

- acquiring companies bringing in investment;
- better terms of employment;
- sending people overseas to learn “how we do things in our company”.

However, there will be losers also – for example, those who no longer have jobs. As economies have recovered there has been a backlash against these acquisitions in some countries by disaffected workers or activists concerned about the loss of national heritage.

All of these factors are putting strain on national cultures, as mergers and acquisitions put a strain on business cultures in developed countries. If understanding and dealing with cultural issues were not enough of a challenge, today’s international managers need to understand these trends and see how they influence the people that work for them. One way of looking at this is to think of the normal distribution of cultural values. The influence of change will be to flatten the bell curve, with fewer people conforming to the norm and more being some way away from it. Alternatively, we might see skewed distributions. If we break the population down by age we might well see cultural norms and values for younger people moving in one direction while older people stay with their traditional values.

How we dress is one of the explicit products of culture but this is also causing problems:
A simple thing, such as changing dress, has created tension and uncertainty that has caused some organizations to rethink. Add to this all the other changes that are occurring and we can imagine that people are having problems coping. This is happening in developed economies, but the number of changes and their pace is greater in emerging markets so we can imagine that the magnitude of these forces at work can be quite significant.

### Changing culture

The above factors are leading to cultural change at a variety of levels – country, region and family. They will also lead to changes in business cultures. These changes are largely unplanned. Sometimes, however, managers seek to change a company’s culture deliberately. This is difficult to do, as it requires a concerted effort over a long period of time and must be done against a background of all the other changes that are going on.

Changing culture within an organization is not easy. It is the subject of many books so we will not dwell on this but there is one aspect which is worth mentioning – mergers and acquisitions. The need to change an
organizational culture is an inevitable consequence of foreign companies acquiring existing businesses in emerging markets. If you want people in your new subsidiary to deliver the same quality of output as your other operations you will be faced with managing cultural change. There are two choices — encourage the people to change or change the people. In practice it is likely that both of these will occur. How far apart the current and desired cultures are and how willing the people are to change will determine the balance between these two approaches. The further the current and desired cultures are apart, the more the need will be to change the people. Some examples are:

- Eastern European companies brought up under communist regimes;
- privatized state enterprises operating monopoly businesses;
- businesses operating in the private sector used to following orders from the owner/entrepreneur;
- businesses where there are no skills in foreign languages or appreciation of how to do business outside the domestic market.

In such cases there is often quite a gulf between current and desired cultural states, which means that the majority of people may well need to be changed. The change is likely to start at the managerial level and it is in such circumstances that bringing in nationals with a Western education can help as they have an appreciation of the desired culture and will be able to get messages across more effectively. They will usually do this with a team of experts from the parent company who will work with local managers and operatives to change working practices, set up new procedures/equipment and increase productivity. People who can adapt will be retained while the rest will be changed. Over time, the head office team will shrink in size and the number of expatriates will be reduced to a small number. The speed at which all this happens will depend on the size and complexity of the acquired business and the pace at which change can be affected, remembering many countries have labour laws which hinder or prevent a reduction in the workforce.

Other situations that may arise are setting up new operations from scratch or with joint venture partners. In the former case it is usually easy as you can recruit the right type of people and train them in your way of doing things. McDonald’s, KFC, Pizza Hut, etc, will take this approach. Where there are joint venture partners it is likely that cultural differences will surface during negotiations but more are likely once an agreement is
in place to do business. Understanding and flexibility will usually be the key to dealing with these situations.

One of the particular factors and influences culture and is worth some more study is language.

**Language**

One of the characteristics of emerging markets, in many cases, is a variety of languages within the country and the need to use another language when undertaking trading activities. This has an influence on culture but also brings its own problems, some of which are:

- a multitude of languages and dialects makes internal communication within a country difficult. In some countries it is easier for people from different regions to use English to talk to each other;
- acquiring language skills is an important part of the education process. Those countries which encourage language skills from an early age have an advantage;
- conducting negotiations may require interpreters to be used, who may or may not translate faithfully;
- foreign owned companies will often use a working language different from the national language but the further down an organization one goes, the poorer the level of understanding of that language may be;
- there is often a need to produce documents in one language for transmission within the organization and another for local purposes e.g. accounts and reports to Head Office may be in English while invoices and reports to local regulators will be in the local language;
- non-local managers are unlikely to know the local language fluently and may cause offence unwittingly;
- English is widely spoken and is generally accepted as the international business language. It is not an easy language, however, because so much of it does not follow the rules. It can be easy for misunderstandings to occur;
- people may pretend to understand what is said to them as they do not wish to lose face by admitting their lack of knowledge.
This list is quite long but it is not exhaustive. These points simply illustrate the fact that language is often a considerable barrier to be overcome when dealing within emerging markets. There are exceptions such as Singapore, the Philippines and parts of Africa where English is a national language, but even in these situations there will be local quirks, and misunderstandings can easily occur.

Lewis covers other issues relating to language in some depth and is worthy of further study. In particular, he discusses non-verbal communications – body language – in some depth as well as issues such as the importance of spatial relationships, like seating arrangements at meetings and physical contacts. He also makes the point that language is not simply about the communication of ideas but influences how people actually think. The fact that other languages adopt different sentence structures or have 20 words where one is used in English are illustrations of how differently people might think.

Like culture, the effective manager needs to be aware of language barriers and deal with them effectively. This usually requires checking for understanding, patience, using simple language, speaking more slowly and clearly, etc. Lewis advocates managers having lengthy and intensive language and cultural training before taking up assignments. It may be time consuming and expensive but the potential rewards are significant.

Language and culture issues in practice

We have covered very quickly and at a high level some of the theory relating to culture which is a very important aspect of dealing with emerging markets and we have also touched on some issues in relation to language. Let’s consider some of the issues that might arise with regard to our case studies.

Call centre – a call centre operating in an emerging market dealing with calls originating from developed countries immediately faces issues over language and culture because the operators must understand what is being said to them and must deal with clients in an appropriate manner. To get the right results extensive training and monitoring are likely to be needed, but firstly the right people need to be recruited. Language skills are clearly important but some understanding of the culture will help. Interestingly, here we have a situation where staff need to deal with cross cultural issues as much as expatriate management do.
An area where cultural issues can be problematic with regard to call centres is working hours. Staff usually work 24 hours a day and will need to be there at times of peak demand in the countries from which calls originate, which may be in the early hours of the morning given likely time zones. This may create problems for people travelling to and from work, especially single females, as there is a greater reliance on public transport than in the West. Working on major religious festivals could also be problematic.

On the plus side call centre staff turnover rates are likely to be lower than in developed countries as they are likely to be better paid and there may be few other alternative jobs.

Construction contracts – large contracts often involve a number of contractors from many countries as well as the client e.g. US main contractor, British, German and Turkish sub-contractors using Indian, Korean and Thai workers on a contract in Malaysia. The potential for cultural conflicts is high, as are misunderstandings due to translation problems, particularly given the need to keep to a contract project plan, meet delivery schedules and hold regular meetings along the way.

Consider dealing with variations. It is inevitable that some changes in the plans occur due to unexpected developments or changes in client requirements. Clients who come from multi-reactive cultures are likely to ask that the changes be made and “we’ll sort it out later”. Linear-active contractors will want to have all changes documented and agreed before they implement them. Meeting client needs can be problematic in such situations and can easily lead to disputes at the end of the contract.

Manufacturing start-ups – establishing a new operation in an emerging market often involves bringing in new technology and working practices which may not fit well with local cultural norms. Time keeping, as we have seen, can be an area where problems can occur. Similarly, team working. Some cultures, for instance, are group orientated, others are individually orientated. If working practices conflict with cultural norms there can be problems as we mentioned earlier when discussing incentive pay schemes. Equally where local managers see that something is not going to work but are unable or unwilling to tell the boss, things are likely to carry on until the inevitable happens – production comes to a halt. Language is another area where there can be problems, particularly when dealing with complex technical areas which it is difficult to translate.
Needless to say these illustrations just scratch the surface of potential issues.

Conclusion

An understanding of culture is probably one of the most critical issues managers need to have when dealing with, or operating in, emerging markets. This is important, because a lack of understanding can create new risks, often unintentionally, or mean that managers are not aware of key risks facing the organization. This lack of understanding, or insensitivity, to cultural issues may also prevent risks from being managed effectively. This will be particularly so where there are conflicts between aspects of the various cultural influences that people are exposed to e.g. national cultural values are usually more deep seated than organizational ones.

Language is one aspect that helps to define culture. There are many aspects of emerging markets which make language more of an issue than in developed markets, especially the large number of quite distinct languages or dialects in use and the fact that international trade and business activities will generally be undertaken in a non-native tongue. The opportunities for problems to occur are plentiful, not least misunderstandings when translating from one language to another.

Summary

- Understanding culture is vital if risk is to be managed effectively in emerging markets.
- The need for this has changed significantly as we have moved from a colonial command and control environment to one where persuasion, rather than power, is required to get results.
- We have defined culture as “the way a group of people solves problems”.
- Culture drives behaviour, it is what we learn not what we are born with.
- We are all subject to a number of cultural influences – tribal, region, organization, etc.
• When faced with problems we may experience conflicts between different cultural influences. How these conflicts are resolved will be determined by the relative strengths of the various cultural influences.

• The stronger cultural influences are likely to be those we have been exposed to longest – nation, family, religion. Organizational cultures are more transient and less deep seated, unless particularly strong.

• Culture operates at a number of levels – basic assumption, norms and values, and explicit products.

• There are a number of dimensions that can be used to explain cultural differences such as whether groups or individuals are more important, whether position is influenced more by achievement or ascription, and the relative importance of the past, the present and the future in determining actions.

• The combination of these dimensions will define, say, a national culture but not everyone will act or behave in the same way. Beware of stereotyping people.

• Within organizational cultures are determined by the actions and deeds of senior management. Strong cultures will develop where these are clear and there is consistency, but weak where what they do conflicts with what they say.

• Strong organizational cultures take a long time to develop but can be undermined very quickly.

• Where the strategy of an organization is at odds with market opportunities the organizational culture will determine how this is resolved.

• Actions taken by managers which go against cultural norms or values are likely to provoke a reaction. Sometimes this is obvious and immediate. In other cases it is subtle and may not be evident for a long time.

• Western influences are becoming more pervasive as satellite TV and internet access spreads, causing aspirations to rise and leading to conflicts with traditional values.

• Those exposed to developed country cultures through periods of study are also driving change in cultural values.
• The nature and pace of changes in recent years are breaking down traditional cultures. Building or sustaining strong organizational cultures is becoming harder for the same reasons.

• Most of the changes occurring in national cultures are unplanned. Within organizations some are unplanned but others are planned or inevitable e.g. when mergers and acquisitions occur.

• When acquiring new businesses in emerging markets there will be a need for the people to change or new people must be brought in. The balance between these two approaches will be determined by the gap between the current and desired cultures.

• Language is a strong influencer of culture. The need to use more than one language is common in emerging markets creating many opportunities for problems to occur.

References


“The management and control of risk is the most significant topic in the business world today”
ROBIN KENDALL

Introduction

Part One addressed the subject of risk and so far in Part Two we have considered the nature of emerging markets and the cultural issues that arise therein. In this chapter we will bring these two aspects together to see what it is about emerging markets that makes managing risk more challenging than in developed countries. In essence, the answer is volatility and uncertainty. Change is more likely to occur in emerging markets and the changes that occur happen more quickly and are more unpredictable. Risk is therefore greater. It is greater in two ways.

- Firstly, emerging markets are different from developed economies and this gives rise to new risks;
- Secondly, risks which have a low probability of occurring in developed countries, have a higher likelihood of occurring in emerging markets.

Not only are risks different, but managing risk can be more difficult. This is because identifying potential risks may be difficult as can finding ways to...
measure them. In addition, some of the techniques used to manage risk may not be available or, where they are, they may not work as effectively as they do in developed countries. It is, for instance, difficult to hedge currency risks when there are no forward markets.

Why is this important? For most businesses their prime objective is to achieve increasing profits with low volatility. Expanding into emerging markets may seem the right thing to do when growth stagnates in traditional markets, but it involves higher risk. Higher rewards may be the justification for this expansion but this needs to go hand in hand with understanding and managing the associated risks. It is inevitable that unexpected events will occur and management must have an open mind and flexibility when dealing with them – simply applying the head office rule book, for example, may well create as many problems as it solves. What some of the pitfalls are, and how they can be dealt with, will be addressed in this chapter. Being aware of these issues will enhance the probability of successfully managing risk in emerging markets rather than being one of the many who have tried and failed.

Risk in emerging markets

We have examined the nature of emerging markets in Chapter 5 and covered in some detail the various physical, social, political and economic aspects that underlie the weaknesses and instabilities that characterize their economies. It is these aspects, when compared to developed economies, which give rise to new risks or increase the probability that situations with higher levels of risk will occur. Let us look at each of these areas in turn.

Physical

All countries differ in terms of size, location, physical attributes (including mineral and other resources), etc, which all impact on risk.

Climate – more emerging markets are located in tropical than temperate zones and they tend to have a higher reliance on agriculture. The simple fact that it is hotter in these countries can create problems but the risk of climatic change is more of a threat. If the rains fail for instance, particularly two or three years in a row, it can have a devastating impact, not only on the part of the country affected, but the whole economy.

Natural disasters – many emerging markets lie in zones vulnerable to earthquakes, floods or typhoons. Taiwan, Turkey and India have all had large-scale
earthquakes in recent years, while the Philippines is regularly impacted by typhoons.

*Location* – distance from major markets enhances transport risks. Being land-locked creates problems due to the need to rely on passage through neighbouring countries to reach sea ports. Denial of access in such circumstances is an ongoing threat.

*Natural resources* – agricultural outputs are vulnerable to weather risks and commodity price changes, mineral resources are equally vulnerable to price movements, exhaustion of reserves or changes in demand due to substitution effects. Increasing concern over environmental damage may mean changes are needed or activities must be stopped.

*Utilities* – under investment in power and telecommunications in emerging markets is not uncommon, leading to weak infrastructure and reliability problems. Power cuts and voltage fluctuations cause untold problems, particularly where this happens without warning. Telephones suffer from similar service problems. Roads and railways are often no better.

We are not suggesting that developed economies do not face risks arising from these factors, but rather that they are more significant in emerging markets. The USA was hit in the nineties by hurricanes and earthquakes, but the impact on the overall economy was modest. This is due to the size and depth of the US economy but also due to risk mitigation techniques such as earthquake proof buildings and insurance markets which are able to absorb the occasional year of high payouts.

**Social**

In emerging markets, social factors that may give rise to enhanced risks include:

*Tribal divisions* – to some people tribe may be more important than nation. In Africa, tribal affiliations often run across borders and it is not uncommon to have animosity between two or more tribes. In some cases this has given rise to secessionist movements, civil conflicts or regional wars – the Kurdish fight which impacts Turkey, Iraq and Iran is a good example. At best there are often under currents and ongoing instability.

*Religion* – as with tribal affiliations, religion can cause increased risk of conflict. This can be between different religions, Hindus and Muslims, or between different religious factions, Sunnis and Shias within the Muslim religion.
Population – the growth rate of population in many emerging markets is of great concern because it is placing increased strain on already stretched resources. Population growth is also resulting in a larger number of people entering the workplace, and is driving increased migration from rural to urban areas. Growth rates have fallen, as education levels have increased, but not fast enough to lower levels of poverty in a number of countries. There is, however, a fairly well established correlation between income levels and population growth so those countries that manage to increase GDP per head have seen population rates drop back, easing these problems. The biggest issue going forward will be unemployment as today’s high percentage of the population under 15 flows into the workforce in the better placed emerging markets.

Health – rising populations and inadequate health services mean that the standard of health is not what it should be in many countries. Various diseases remain problematic – malaria, typhoid, etc – but the greatest concern today is AIDS. In several African countries it has led to the deaths of a significant proportion of the male adult population. Their wives are generally also affected and increasing numbers of orphans are resulting. The economic impact of losing a key part of the workforce is significant. Cultural issues have led to problems in firstly recognizing AIDS as an issue, as it may be seen as a weakness, and, secondly, dealing with it, because this requires change in traditional practices in male dominated societies.

Economic

Economic vulnerabilities arise due to fundamental weaknesses or poor management. Reliance on income from a few commodities whose prices fluctuate wildly is an example of the former, governments continuing to operate managed price systems for staple goods is an example of the latter. Some of the issues giving rise to increased risks in emerging markets are:

State control – in developed economies state ownership has been scaled back considerably over the past 10–15 years. In emerging markets the tendency to hold on to “key” sectors such as utilities, financial services and transportation remains. In such situations these enterprises tend to remain starved of investment funds and lack the management skills required to operate in an increasingly competitive environment. In some cases privatization has occurred but ownership has simply been transferred to persons well connected to the government at knock down prices. This has increased the risk of failure rather than improved service quality and reliability.
Protection – continuing to protect domestic industries increases the risk that they will fail when they are eventually faced with external competition, as they inevitably will. It is interesting to note that those countries that had opened up their banking systems to foreign ownership/competition fared much better in the Asian crisis than those that had not.

Managed prices – while it may win votes, keeping down the price of essential goods is a costly exercise that it is difficult to break out of. Many emerging markets continue to subsidize basic foodstuffs such as bread and rice or fail to recoup the production costs of water, electricity, petrol or gas supplies. The case study of Enron problems in India highlights how low electricity prices have led to difficulties with the Dadabhol project.

Poor spending decisions – government spending is often wasted on grandiose plans and purchasing armaments, is eaten up in supporting an inflated and underperforming bureaucracy or used to support managed prices. The lack of accountability in the political system means that there is little challenge – parliament and even ministers can easily become simply rubber stamps for strong leaders. In such an environment it is easy to see how substantial funds can be siphoned off into personal bank accounts.

Inadequate tax base – high spending can be accommodated where there are adequate revenues but many emerging markets have an inadequate tax base. Generally this is because the proportion of the population earning wages of any size is not high and those that do have high earnings are able to avoid tax through corruption, bribery, false accounting or use of the grey economy. Import duties and sales taxes therefore remain significant sources of income. Better control on spending would help, but changing this is a political challenge from which many governments have shied away. Extending the income tax base or simply improving the efficiency of tax collection could make a substantial difference in a number of countries.

Debt burden – a consequence of high spending and inadequate income is often a significant debt burden. Financing this by printing money is easy to do but inflationary. Borrowing in foreign currency is possible but increases vulnerability to market risk unless there are adequate sources of foreign currency. Where a high percentage of foreign currency earnings is committed to servicing extended debt little may be left for essential imports.

In some cases these factors preclude the development of the means by which risks can be mitigated.
**Thin financial markets** – in small countries or those dominated by state banks, the size of financial markets is likely to be modest and their level of sophistication low e.g. most African countries. Even in larger markets the degree of volatility in exchange rates or interest rates may be such that it is difficult for markets to develop in size or depth e.g. Turkey. Insuring or hedging risks in such situations is problematic.

**No or small capital markets** – the availability of capital is a key driver of economic activity in developed economies. There needs to be sufficient people or institutions willing and able to invest in companies, an available market place (stock exchange) and adequate liquidity to ensure the market works effectively. In recent years there has been a rapid growth in the number of emerging markets with stock exchanges but they suffer from a number of problems. These include:

- lack of depth – too few stocks or a few stocks dominate the market index;
- illiquidity – family businesses often want to realize capital gains but often float only a small proportion of stock (10–20 per cent). Daily trading volumes are small and prices can be volatile as a result;
- lack of transparency – stock exchange rules often do not require the level of disclosure seen in developed markets;
- different accounting standards used – accounting standards do not always meet international standards. Consolidated accounts, for instance, are often not available.

The result is thin markets and great volatility. Even where there are reasonably sized markets they do not operate in the same way as developed stock markets given the low percentage of company share capital traded. As a consequence, hostile takeovers are almost unheard of in these markets. Table 7.1 sets out some of the percentage changes in major emerging market stock markets for the first four months of 2001. This is shown both in local currency terms and US Dollars.
These numbers show quite clearly the high degree of volatility in these markets but also the impact of currency movements. The Turkish Lire, for instance, was devalued in the first quarter of 2001 wiping out the significant gains in local currency terms. Such thin and volatile markets create problems for businesses wanting to raise capital but have often been seen as an opportunity for investors. This has not always been a fruitful endeavour. Higher risk and reward go together but in the case of emerging markets risks arise not only because of the structural problems we have highlighted above, but because of perceptions of investors, fund managers and speculators. Large and rapid movements of funds can spark or enhance economic crises, despite the local and international support. Gill Tudor’s book *Rollercoaster* (2000) covers this ground very well, explaining in detail how the various crises in the nineties enveloped Latin America, Russia and the Asian countries.

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<th>Country</th>
<th>Percentage – local currency</th>
<th>Percentage – US Dollars</th>
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<tbody>
<tr>
<td>Hong Kong</td>
<td>–10.0</td>
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<td>India</td>
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<td>Malaysia</td>
<td>–15.7</td>
<td>–15.7</td>
</tr>
<tr>
<td>South Korea</td>
<td>+14.7</td>
<td>+11.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>+15.8</td>
<td>+10.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>–5.3</td>
<td>–18.2</td>
</tr>
<tr>
<td>Turkey</td>
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<td>–24.2</td>
</tr>
<tr>
<td>Poland</td>
<td>–18.0</td>
<td>–14.4</td>
</tr>
<tr>
<td>Russia</td>
<td>+37.6</td>
<td>+36.1</td>
</tr>
</tbody>
</table>

*Source: The Economist – 12 May 2001*
What is important to draw from this section is that structural weaknesses exist in all emerging markets and how the government handles the economy has a significant impact on future prospects. Changing direction and breaking away from old paradigms requires clear and consistent policies pushed through over a long period of time. Some of the emerging market success stories, Singapore and Chile, for instance, show how this can be done. Russia is an example of a country where things have not gone well. It certainly has good long-term potential but in the short term significant problems remain.

Care is needed even when looking at the good examples as there have been "false dawns" before. Many were caught up on the tidal wave of economic growth that carried Asian economies forward for over a decade or more, only to find out that there were more risks around than they realized. Much as inflation helps reduce the real value of debt, growing economies
allow inefficient companies to survive and grow. In such circumstances governments were able to postpone, or never saw the need for, fundamental reforms. Now there is more recognition of the need for foreign investment and the transfer of technology and know-how, but there is a shortage of political will or economies are too fragile to support the changes needed to attract and retain investors. This means that risks have, in some areas, increased further. Differentiating between those countries committed to change and those which say the right things but fail to achieve much is even more important now than previously.

**Political**

It is often the political situation in emerging markets that generates the greatest degree of risk. This is particularly so in countries where there is a strong leader who has been in power for a long time. The saying goes “power corrupts but absolute power corrupts absolutely” and there are many examples of this. In particular, leaders hanging on to power, almost in desperation, usually cause instability as the following case study indicates. This is not the only case of an economy being wrecked by political events.

**Final fling?**

During 2000, “war veterans” occupied many farms in Zimbabwe. The government of President Mugabe apparently supported the occupations and no action was taken to evict the squatters even after several deaths.

Elections in the same year were hotly contested but despite strong arm tactics from Mugabe’s ruling Zanu-PF party, the opposition gained a strong foothold in parliament. There is clear opposition to Mugabe’s continued occupation of the Presidential position but there is every indication that he intends to stand for re-election. The opposition leader has been arrested and a number of his supporters attacked.

The result has been growing unrest as the economy, which had every prospect of being one of the strongest in Africa after gaining independence, has been decimated as illustrated earlier.

Traditional supporters are no longer offering aid and without political change and a strong leadership with popular support, it is hard to see how the economy will improve in the foreseeable future. As such, we can hardly consider Zimbabwe to be an emerging market as its GDP per capita level falls year by year.
Some of the political aspects of emerging markets include the following.

*Power base* – some form of democratic election process now operates in more countries than has ever been the case but there are many variations on a theme. A democratic process that has only one party on the voting slip is hardly a democracy. Neither is one where other parties are permitted but are so disadvantaged that they cannot form an effective opposition. Disadvantages may be funding, access to the media and arrest and imprisonment of leaders. Physical attacks of candidates or bribery of the electorate is not uncommon. In such situations, a leader’s power base is claimed to be the people and the constitution but is more likely to be the military which is sustained through control of the government machine and cronyism. Opposition in such situations is definitely a dangerous activity as the problems in Zimbabwe illustrates.

*Patronage and cronyism* – remaining in power requires support from various sectors. Support is either won or bought. More often than not the latter prevails in emerging markets. Favours and concessions are given, contracts are awarded or positions of power are granted which give friends, relatives and supporters power and the opportunity to accumulate wealth. They in turn often use patronage to support their own positions. This means that decisions are not made, necessarily, on rational grounds. In addition, patronage can be taken away as well as given and people often fall as fast as they rise. Being too closely associated with those in power increases risk for businesses – joint venture partners or sponsors must be chosen carefully.

*Legal/regulatory framework* – in some emerging markets there is a sound legal structure, usually a legacy from past masters, but this is not always the case nor is it always true that laws are developed and expanded to deal with changing times. Laws may be lacking completely e.g. those covering bankruptcy and property rights or may simply be out of date. Alternatively, they may exist but not be applied either at all or consistently. The same is true of regulations. It is not uncommon for new regulations to be introduced overnight with little thought and no consultation. Withdrawing them would be considered a loss of face so they remain in place and many “clarifications” are issued. These clarifications sometimes cause as much confusion as the original rules. Knowing the law and regulations is therefore not enough. You have to be prepared for, often unpredictable, change at short notice. Malaysia’s re-imposition of currency controls in 1999 is a good case in point.
Corruption – it is not inevitable that corruption occurs in emerging markets but it is quite common. Low wages and high costs of living make it difficult for people to make ends meet without getting payments for services or favours. For businesses, giving bribes can create as much risk as not giving them and a fine line has to be drawn when dealing with the subject. Most recognize the need for "low level facilitation" but would rather not know or be directly involved e.g. using middlemen to get a telephone line installed that would otherwise take months or years. Direct or other loosely disguised bribes to acquire business, especially large and high profile contracts, is a different story and needs to be avoided as the many revelations of such happenings in recent years show what can happen if these things come to light.

Lack of transparency – it is difficult to understand risk without adequate information. This is in short supply in emerging markets partly because of cultural issues, giving too much away is a sign of weakness and reduces bargaining power, but also because rules and regulations limit the amount of disclosure required. Stock market rules and accounting standards are good examples that we have already touched on.

Conflict – a number of the factors mentioned above give rise to the potential for conflict, both internal and external. This can arise from long running causes of tension such as religious or tribal differences or from growing discontent with the ruling faction. The former has given rise to a variety of, sometimes long running, conflicts, guerrilla wars or secessionist movements, particularly in Africa and Latin America. In some cases, popular uprisings have led to the overthrow of leaders such as Marcos in the Philippines and Suharto in Indonesia. The initial euphoria and honeymoon period lasts a short while only, however, if real progress is not made. The transition from white to black rule in South Africa, for instance, has not met the expectations of the people. The Philippines and Indonesia are again going through periods of unrest. The unpredictability of events gives rise to business risk in addition to the risks to personal safety and business assets. Kidnapping has become an increasing source of income to support rebels in recent years and foreign nationals/companies are predictable targets. To a large extent it is not the known or more common risks which lead to problems for companies investing in emerging markets, but the more unusual or subtle ones. We have mentioned many above, but they are usefully brought together in the Grey Area Dynamics™ framework developed by Merchant International illustrated in Fig 7.1.
This framework sets out a range of issues that can be classified along two axes legal–illegal and passive–non-passive. Which of the many issues listed is of particular importance for your proposed investment or ongoing business activity will depend on the country you are planning to invest or operate in, the location in that country and the line of business. The basic principle remains, however, that to manage risk effectively requires each of the above segments to be reviewed and addressed.

**Risk factors are inter-linked**

We have covered a wide range of factors that can create enhanced risk situations in emerging markets. They do not operate in isolation, as the case study on Zimbabwe suggests. Consider the following.

*Turkey* – in 1999 Turkey was hit by a large earthquake and large numbers of people died. The death toll was higher than would otherwise have been the case because of poor construction methods. Builders had cut corners or flouted building regulations while supervisors and building inspectors
“looked the other way”. The potential problems were not unknown but were put aside for personal greed. Corrupt practices combined with a vulnerability to earthquakes meant more people lost their lives and there was more destruction than should have occurred. The cost to the economy was, therefore, significantly higher. Interestingly, many multinational companies had premises in the area the earthquake hit but suffered relatively little damage as they were built to company specified not local standards.

_Nigeria_ – similar to Zimbabwe, Nigeria was an economy that gained its independence with good prospects. A major strength was its oil resources that brought in significant revenues after the oil price hikes of the seventies. Instead of building a strong economy much of this oil wealth was frittered away or stolen by a succession of corrupt leaders. Corruption became endemic and physical safety a problem. Basic infrastructure has been allowed to crumble while population growth has remained high. External debt grew and had to be rescheduled. Now, despite greater stability and democratically elected leadership, who are aiming to reduce corruption, it will take a considerable effort to resuscitate the economy.

We could continue but these examples serve to illustrate the point that emerging markets generally cannot change the hand they have been dealt, but they should seek to use their scarce resources or competitive advantages wisely. To do this they need to ensure that adequate attention is paid to the various social, political, economic and physical aspects which help or hinder economic development and that any actions taken are consistent with maximizing development potential. Unfortunately, this has not always been the case due to missed opportunities, poor management or misappropriation.

How a country has developed over time will impact on its culture which, as we have explained in Chapter 6, is something that needs to be understood when dealing with emerging markets.

**Culture**

We have covered culture in some depth in the previous chapter. We now need to consider how it impacts on risk issues. Remember that we have said that “culture is the way that a group of people solves problems” and the above analysis indicates there have been, and continue to be, plenty of potential problems. Certainly many emerging markets have had a troubled history during the 20th century, having had to face many economic and political challenges over the years. These problems have been dealt with
through drawing on their culture and traditions. In recent years the pace of change has been such that culture and traditions have been challenged leading to changing views and practices. This is likely to accelerate and this is causing social and other problems within emerging market countries. We will consider just a few examples of the risks that may arise.

*Changing values* - success built on one set of values and business practices may no longer be sufficient to guarantee success in the future. Drawing too heavily on the past can mean that management become blind to potential risks or that the traditional ways to deal with risk are no longer appropriate. As governments respond to pressures for more transparency, and democracy forces the need for more legitimacy, the pressure will increase. The downfall of many of the large industrial groups, or chaebols, in South Korea illustrates this only too well.

**Generational challenge**

Many emerging markets are dominated by a small number of business groups who were founded two or three generations ago. They were often built up by hard working but not well-educated entrepreneurs who started with very few resources. They succeeded through hard work, reinvestment of profits and taking risks. Luck played a part, but so did building and developing strong networks. Business deals were done on a handshake that was considered stronger than any contract.

The founding fathers of these groups are now elderly or have passed away leaving second or third generations to come through and run them. The third generation, in particular, were brought up in better living conditions, are often used to wealth and have studied at top universities and business schools. They understand about contracts, balance sheets and strategic planning but how can they reconcile these core elements of Western business management with norms and values based on ascription and merit, family connections and relationships and the blurring of business and non-business activities?

It is a fine line to tread and can create dilemmas which are difficult to resolve given that past practices have clearly brought success.
Contracts – attitudes to contractual obligations vary enormously. Failing to understand the difference in cultural attitude increases significantly the risk of dispute (legal risk). Do not forget also that language is important, as the language of the contract is likely to be the second language for at least one side in the negotiations. Misunderstandings of the meaning of key sections and translation errors are a common problem. We should also mention that many large contracts are signed with government entities. If they do not wish to honour their commitments what do you do? Sue them? It may not be wise to do so if you wish to do more business in the country, but there comes a time where there is no point in staying if you do not get paid.

Other cultural problems that can give rise to risk issues include the following, some of which we have already touched on.

Offending religious values – McDonald’s have had restaurants trashed after facing religious objections to the use of beef. Importers of tyres and shoes, amongst others, have found their goods banned in Muslim countries after patterns on them were said to insult Islam.
*Keeping face* – it is very important in some countries that face is not lost. Negotiators run the risk of giving offence and losing business through simple things such as not sending senior enough people or not having a matching number of representatives in their negotiating team.

*Time keeping* – some cultures do not consider keeping time to be so important and meetings are expected to start when everyone is there, not necessarily at the allotted hour. To start without key people can risk giving offence.

*Group incentives* – we have already mentioned that putting in place an individual reward structure can lead to less business being done rather than more where groups are seen as more important than individuals.

These few examples and those mentioned in Chapter 6 show how important it is to understand the culture of the country in which you are operating or doing business with. Not only is this important but you must also understand your own culture well in order that you can address the cultural differences effectively. How important this is can be seen from the results of research that one in three American managers “fail” in overseas assignments. For UK nationals the figure is around one in seven. The reasons for these “failures” often comes down to an inability to adapt to the culture of the new location – so called culture shock. Elisabeth Marx in her book *Breaking Through Culture Shock* suggests that some of the key problems are:

- lack of control – cultural barriers create problems of understanding;
- not knowing what to say – how to address people without causing offence yet being seen as effective and not weak, can be difficult;
- language – simply not understanding what is said;
- family stress – unhappy wives and families increase stress;
- boredom – outside activities may be very limited;
- focal point – being a foreigner raises your profile, appearing to be privileged can provoke jealousy (accommodation benefits for example);
- travel – many positions require much travel within or between countries or back to Head Office, meaning families are left on their own;
- time zones – getting hold of people may be difficult so business calls at home in the evening are not uncommon.
Some or all of these problems will occur in every location and culture shock is almost inevitable. The degree of culture shock will depend on the location and its environment to a certain extent, but the attitude and expectations of the individual are key. People transferred to emerging market environments may suffer higher degrees of culture shock because the gulf between what they have been used to and what they must now cope with can be quite great e.g. if basic utilities do not work, roads are poor, houses are fortresses rather than homes, etc. The gulf is not so great in all emerging markets, however, as there is less of a difference between moving from New York to Hong Kong, than there is to Nairobi or Mumbai or Beijing. The costs of failure for both the business and the individual are significant so making sure that people managing businesses in emerging markets are aware of and can deal effectively with cultural issues is very important. Failure to do so can significantly increase risk.

Having spent some time highlighting areas where the risks in emerging markets may be different or enhanced let us now consider the three step process of identification, measurement and management, and what the impact of emerging markets is.

Managing risk in emerging markets

Identification of risk

As you will recall this is the first and most important step in risk management as risks which are not identified are unlikely to be managed. We have covered in detail various aspects of emerging markets that increase the level of actual or potential risk. Simply being aware that there is more risk around is, in itself, not very helpful, however. This heightened awareness needs to be translated into action which should, first and foremost, include being more proactive in trying to identify the specific risks associated with current or future business operations.

To start with it is useful to look at the risk areas that we have covered in detail in Chapter 2 and see what issues will impact on them. A summary of the key points is set out in Table 7.2. A number of these have been touched on at various points so far and it provides a useful summary of the factors which may well hinder the identification of actual risk.
<table>
<thead>
<tr>
<th>Risk type</th>
<th>Issues in emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>• whole range of issues make emerging markets more volatile and unpredictable so companies which are not well managed and robust financially will be vulnerable.</td>
</tr>
<tr>
<td>Credit</td>
<td>• lack of transparency, limited disclosure (accounting risk); • counterparty unwilling to share information; • inter-connected businesses common.</td>
</tr>
<tr>
<td>Credit–sovereign</td>
<td>• credit risk of the sovereign entity will generally be well known. It may be weak due to dependencies on external factors such as exports, investment inflows or poor management of income and expenditure.</td>
</tr>
<tr>
<td>Market</td>
<td>• exchange rates and interest rates liable to move significantly and with little warning; • two-tier exchange rates may operate (official and black market); • pegged exchange rates, currency boards or crawling peg mechanisms may operate but limited resources to defend them leaves them vulnerable to speculation.</td>
</tr>
<tr>
<td>Liquidity</td>
<td>• often high degree of reliance on central bank which may have limited resources, particularly in time of need.</td>
</tr>
<tr>
<td>Operational</td>
<td></td>
</tr>
<tr>
<td>– staff</td>
<td>• quality and quantity of staff will vary enormously as will work ethic and time keeping; • may be volatile, willing to strike or down tools at short notice and for apparently minor grievances; • cultural issues very important; • shortage of skilled local managers with adequate language skills and an understanding of business practices in developed economies, vulnerable to poaching by competitors.</td>
</tr>
<tr>
<td>– technology</td>
<td>• technology in use may be outdated and difficult to maintain; • computer systems vulnerable to communication and power availability, technical support may be limited.</td>
</tr>
<tr>
<td>Table 7.2 continued</td>
<td></td>
</tr>
<tr>
<td>---------------------</td>
<td></td>
</tr>
<tr>
<td><strong>– outsourcing</strong></td>
<td></td>
</tr>
</tbody>
</table>
| • if contracts have little meaning this may increase risk considerably if service standards are not met;  
| • may be limited back up. |
| **– fraud**          |
| • heightened vulnerability particularly where management has limited understanding of local practices or there is collusion amongst staff;  
| • may be cultural blindness to fraud – company is rich therefore stealing is OK. |
| **– external dependencies** |
| • utilities may not be available when wanted or get cut off without notice;  
| • transportation problematic, particularly in out of town locations;  
| • physical security may be a problem – plant and personnel. |
| **– processes and procedures** |
| • need to be adapted to local conditions, including compliance with local regulations;  
| • language problem, may need dual language systems. |
| **Accounting**       |
| • accounting standards weak, income sources and profits often understated. |
| **Country**          |
| • limited resources and/or poor management may increase vulnerability to currency shortages and the need to ration available foreign exchange holdings. |
| **Political**        |
| • power tends to be concentrated and is open to abuse even in nominally democratic countries;  
| • change may come quickly and suddenly or after a prolonged period of rising unrest. |
| **Industry**         |
| • often only a few key industries which are vulnerable to external factors such as commodity prices, levels of tariff barriers, exchange rates. |
| **Environmental**    |
| • lower standards or non-enforcement may reduce environmental risks but this is changing and poor practices today may store up problems for the future (cf. asbestos in US where litigation 30 years after the event is causing companies to seek protection from creditors). |
Table 7.2 continued

Legal/compliance • problems can arise through a lack of understanding, unclear requirements, lack of enforcement or laws not being in place;
• resolution of legal cases can take many years;
• major problem is sudden change, new regulations or enforcement of requirements which have not been enforced before, corruption may be endemic.

Systemic • increased interconnectedness with the outside world as trade barriers are removed and deregulation occurs are creating opportunity but make emerging markets more vulnerable.

Reputational • international companies in emerging markets are prime candidates for adverse publicity. This may be vindictive.

In some areas identifying the risks may not be a problem but the volatility and unpredictability of change will be. This is particularly so for exchange rate movements and interest rate changes where high volatility is well known but what is not is when, and how much, change will occur. In other areas identification of risk is much more problematic but again boils down to unpredictability – where are new problems going to come from – and scaling – how big an impact is this going to have. Much of this uncertainty arises from the significant impact that political events can have on the economic environment – often as a result of increasing or decreasing confidence of outside investors.

This uncertainty is enhanced by the increased connectivity that emerging markets have with the rest of the world, which has made them more vulnerable to external shocks such as rising oil prices, falling demand from major markets or changes in US interest rates.

The Asian crisis illustrated how these linkages have increased over the years but what is the state of play now? As the following illustrates it is becoming even more difficult to see where risks are coming from due to the structural changes about to start, started but not finished, started and abandoned, or completed but not working. With Asia facing a further downturn, failure to address these issues will continue to make these countries vulnerable.
In the aftermath of the Asian crisis, actions were taken by a number of governments to address the structural weakness that the crisis had highlighted. In some cases, this was a condition of support from international organizations such as the IMF.

In practice, a number of initiatives have started to unwind and expectations are not being met. This has happened because of social unrest caused by the various changes, as unemployment has increased and living standards have dropped, and changes in government. In addition, a return to economic growth quite quickly, reduced the pressure for change. Even where change has occurred, such as putting in place bankruptcy laws in Thailand, practical problems are reducing their effectiveness.

What these events are doing is undermining the confidence people have in governments to put in place the important building blocks necessary to make emerging markets more successful in the long term. Long term economic improvement is being jeopardized therefore, but, in addition, risk is being increased short term due to the heightened levels of uncertainty and the impact of the disturbances caused by social unrest. The result is planned investments in a number of emerging markets are being postponed, cancelled or diverted to more attractive markets. Even aid flows have been curtailed in some areas.

The message is fairly clear for governments. Decide the future direction and then ensure that it is achieved. This will reduce uncertainty and help its achievement.

These factors are largely outside the control of businesses but they do have a choice of whether to play or not. These factors define the level of business risk (see Fig 2.2) and it is management’s choice how and where they make their investments, taking into account possible risks and the expected levels of return. What businesses do, how they operate and whom they employ are, therefore, within their control and poor decisions can enhance risk. One of these important decisions is whether to enter an emerging market alone or with a local partner. In some countries there may not be a choice. Where this is not a legal requirement companies still use local partners as they are seen as a way of reducing risk through lever-
Emerging markets and risk management

agaging off local knowledge, connections, or existing resources such as established distribution networks. In practice these partnerships can create more risks than they reduce. Reasons for potential problems are:

- cultural differences;
- personality clashes;
- different priorities and timetables, hidden agendas;
- lack of openness;
- inability to deal effectively with crises when they occur, unable to agree on a strategy or unwilling to commit additional resources;
- downfall of well connected patrons.

Unless there is a coincidence of objectives and openness it is more likely that problems will arise in using local partners. Care is needed therefore to identify potential areas of risk and deal with them early because unwinding such arrangements can be problematic and costly. It is not a coincidence that emerging markets that have relaxed their rules on minimum foreign ownership have done better than those that have not.

If we can get over the first hurdle of identifying risk, what problems are there with measuring risk?

**Measurement of risk**

Putting a value on risk exposures is not that easy, even in developed markets. This is particularly true for the types of risk that do not lend themselves easily to numerical analysis, such as systemic and reputational risk, or for situations where there are a number of different risks involved. Trying to evaluate risks in emerging markets can be much more problematic, partly for reasons already mentioned – lack of transparency and/or willingness to disclose information – but also for a variety of other reasons.

The key problems are:

**Sources of data** – the depth and breadth of data sources available in developed markets does not exist in most emerging markets. Take two examples:

- credit bureaux – few credit bureaux exist in emerging markets and those that do have struggled to deliver reliable information, making it difficult to undertake credit checks;
- government statistics – government departments are usually a prime source of data, but in many countries statistical collection either does not exist in any meaningful way or it is poorly done.

Quality and quantity of data – where there are data sources the quality and quantity available is often poor. Historical time series data tend to cover short periods only and the breadth of coverage is narrower than developed markets e.g. data on interest rate and exchange rate movements may be available only for a few years rather than decades. Quality is compromised by poor data standards and lack of quality control in data collection is not helped by a general underfunding of this area by many governments.

Accessibility – what little data there is, is often paper based limiting access and constraining the ability to turn this into useful information. This is changing but converting systems to on-line access, for instance, is time consuming and expensive and most emerging markets consider this low priority. Conversion errors are not uncommon.

Timeliness – data made available can often be of little value due to it being quite old. It is not uncommon for company balance sheets to be prepared two or three years after the year end, a consequence of poor discipline and weak tax collection regimes. Government GDP or balance of payments data can be several months or more, out of date.

Culture – in many societies there is resistance to giving or using information, so people may deliberately withhold information or lie when asked to complete census forms or similar. In addition, managers are more used to managing through gut feel and developing relationships so “management by numbers” can be quite alien to them – particularly older generations. Indeed, this conflict of management styles is one of the main problem areas when international companies use local partners.

Most of these factors relate to external issues with regard to the collection of data, but even within a business, some of these problems can arise for reasons covered in Chapter 3. There are other dimensions to consider including:

Customer identification – keeping records of customers can be difficult as many countries do not adopt the same “first name, last name” convention used in most developed countries, indeed some do not use surnames at all.
In Asia it is not uncommon for additional Western names or shortened versions of long names to be used, complicating matters further. ID cards help cut through the confusion but are by no means infallible.

**Reporting standards** – Head Office reports which require completion by a certain date and in a prescribed format, will usually be delivered, but the report may contain what local management think Head Office want to see and may not necessarily reflect the true situation. Similarly, any instructions such as “report immediately to Head Office any major problems” will have a cultural spin attached. Some countries will never report anything, as they do not like to give bad news, others will report the most trivial items, for fear of getting caught out by audit or inspectors. People reviewing reports in Head Office need to understand these issues and not, necessarily, assume that everything meets their expectations. This issue not only applies between an overseas unit and Head Office, but will also apply within a country – bad news may well not reach the top (until it is too late). In addition, cultures that favour groups over individuals are likely to seek to suppress information which pins blame on a particular individual.

**Models** – companies use a variety of models to measure risk but these models are generally built in Head Office where there are skills and data sets to construct and validate them. More often than not they will not work in emerging market situations because the underlying drivers of risk are different and the lack of good quality data.

Using an inappropriate model can be more risky than not using one at all.

**Language** – simply explaining what is required may run into language barriers. A more subtle issue is the fact that people whose first language is not English may think differently. Even though they may understand the words as translated to them, they may not understand their meaning.

All of these things make it more difficult to get a clear picture of risk both in terms of the size of risks but also the probability of risk events occurring in emerging markets. Remember we said in Chapter 1 that people’s views on risk are influenced by culture and other facts, so it is not surprising, therefore, that people in Head Office may view things differently from those on the ground or that foreign and local managers attach different probabilities to potential outcomes.

Knowing these things, however, management needs to ensure that they treat data carefully, are not blind to the quality issues, and seek to validate
what they are provided with from more than one source, preferably independent ones. In many emerging markets successful foreign managers build up a network amongst people in the company who provide them with information “off the record”, including such validations. These networks can also give advance warning of potential risks or problems. In recent years Western educated or trained managers have been employed to bridge this information gap, but they are generally insufficient in numbers and it is not uncommon for them to move companies regularly.

In summary, measuring risk in emerging markets is problematic but not impossible. The good news is that the number of sources are rising and quality is improving, while technology is increasing accessibility. There remains a long way to go.

Management of risk

Given the preceding list of potential pitfalls, it may seem surprising that there is such interest in emerging markets. There are, however, ways to address both known and unknown risks that can help ensure that earnings potential is maximized and the possibility of loss is kept to a minimum. To do this we have said that the following are needed:

- a coherent strategy
- an effective risk management framework
- robust but flexible implementation.

Strategy

Managing risk starts with setting strategy. Given the higher risk associated with emerging markets, getting this right is quite important, particularly if planned investment size is significant. Arnold and Quelch in ‘New Strategies in Emerging Markets’ suggest that the best approach is to look at long term profit potential and the ability to convert this to actual profits. A summary of their model is set out in Fig 7.1 and categorizes target countries into four segments based on these two criteria. Using this analysis it is fairly clear that priority should be given to the leading markets, the top right hand quadrant, and trailing markets, bottom left hand quadrant, should be de-emphasized. Those looking for short term gains would probably focus on aggressive investment countries, bottom right, while those taking a long term view are more likely to emphasize platform investments, top left.
Until the Asian crisis many of the Asian emerging markets such as Thailand and Indonesia would have been considered leading markets, but the ability to generate short term profits is now problematic and long term prospects have been scaled back. India, Brazil and China are other markets with considerable long term market potential that could be classified as leading markets, but many companies have been unable to turn this into actual profits (though it has not stopped China being ranked as the third most popular country for foreign inward investment in recent years). Russia is more clearly in the platform investment category, while countries such as Chile and South Africa are sound short term investments but have limited local markets, meaning that long term opportunities require them to become regional hubs. Many African countries will fall in the trailing markets category.

This approach is a useful starting point, particularly as it can help pinpoint potential target investment countries, but strategic decisions cannot be made without considering the risk side. To do this, details of strategic options need to be set down, risks assessed and a decision made.

Strategic options need to consider various aspects including:

- how large an investment is proposed?
- is investment to be simple market entry, joint venture operation, take over of an existing business, or other options?
- when is investment planned?
• what products are to be launched? Are they positioned in the luxury or mass market?
• is it intended that the company be a prime mover or a follower?

As we have seen when considering Ansoff’s Matrix (Fig 4.4) entering new markets with existing products is more risky than staying in a known market, so care is needed. Product strategy, in particular, is important as the following case study shows.

A different breakfast

In the early nineties, Kellogg’s launched its famous breakfast cereals in India. A few years later total sales remained very small. Why?

Breakfast cereals did not strike a chord with Indians as convenience foods were not something that they needed. Breakfast was either prepared at home by the lady of the house or by servants. Many people simply grabbed something from a roadside stall on the way to work.

To address this, Kellogg’s adapted their product to the market by launching a breakfast biscuit which sold cheaply at the roadside stalls to much greater success.

This illustrates the point that many multinationals have overlooked. Simply parachuting in well known brands to new markets is no guarantee of success. The products are either not appropriate or consumers are unwilling or unable to pay premium prices for the brands. Washing machines may be a great boon to working mothers but do not sell well in emerging markets where most cannot afford them and those that can, are quite likely to have servants to do the washing. Some years ago all the talk was about global brands, but even McDonald’s adapts its menu country by country to cater for local tastes and income levels. Now the talk is “think global act local” but not everyone is willing to back this with the investment it requires to meet local needs more effectively. Not doing so increases the risk of failure quite considerably. For further discussion on this subject the paper by Arnold and Quelch is recommended reading as it covers this in some detail and has useful insights on how companies might approach product development in emerging markets.
Having decided the strategy, risk assessment is needed. One way to do this is to bring in outside experts who can add another dimension through looking at a variety of risk issues which would be difficult to assess from the outside or without specialist knowledge. They will report on areas such as economic and political stability, corruption, environmental risks, physical security issues, and provide profiles of key players, including potential business partners, as well as provide unbiased assessment of proposals (See Grey Area Dynamics™ above). Such reports will clearly need to be supported by input from within the business prior to making a final choice but the importance of having such as independent view is increasing. Though such reports may not come cheaply, if they reveal potential pitfalls which could cost much more later on, they are a worthwhile investment.

Another angle to consider is cultural fit. It is quite common for businesses to invest in countries that they have close affinities with. Such affinities can include language, historical connections, similarities in legal systems, religion, etc. These need not necessarily be the nearest countries to the home base, but they may be ones that are “spiritually” closer. Ignoring this cultural dimension may heighten risks, so it needs due consideration in the decision-making process.

At the end of the day, making strategic decisions involving investment in emerging markets is always risky, but provided this is done with care, the level of risk can be minimized. Risks will, however, continually change so it is important that there is an appropriate risk framework in place and flexibility to revisit the strategy if circumstances warrant it.

**Risk management framework**

We have earlier defined the risk management framework as the structure within which the management of risk is effected within an organization. What this risk management framework looks like for a business operating in an emerging market environment will depend on an analysis of the various factors set out in Table 4.1. We have, however, already made it clear that an emerging market environment is likely to be a higher risk one, and therefore we would expect that it would be necessary for one or more of the following to happen:

- additional resources to be invested in risk management;
- tighter control to be exercised on decision making, particularly investment decisions;
- more detailed or more frequent reporting;
• more experienced people to be put in charge of the business or key areas.

The more aggressive the strategy and the more volatile the market the more important it will be to consider these factors. For companies that are generally run on a decentralized basis it is likely that they would need to have a higher degree of control than normal, especially in the initial phases. Setting up a new business in China, for example, would need a different approach than expanding an existing business in the United Arab Emirates.

We can explore this a little further by looking at the various elements of the risk management framework and considering how these will operate differently in emerging markets.

**Roles and responsibilities** – clarity is needed on who does what. This is of greatest importance where joint ventures or partnerships are set up, or where there are foreign and local managers of equivalent rank. There also needs to be clarity on the boundaries between local and head office management responsibilities.

**Delegation of authority** – what can local management authorize? Command and control organizations limit authority to the minimum, but this means many things must go up to Head Office. There needs to be a balance between control and pragmatism. The greater the degree of trust in the people receiving authority, the greater the level of authority that can be delegated.

**Policies and procedures** – again these will be plentiful and detailed in command and control organizations but emerging markets do not necessarily fit the same mould as the home market, where such policies and procedures have been tried and tested. An appropriate balance is needed. The preference is for a lighter touch with Head Office setting high level policies and guidelines which local management must develop into more detailed documents locally. If done well, this will mean that requirements fit with local needs and there can be no misunderstanding or translation problems with Head Office specifications. This approach can run into cultural barriers as some people prefer to be told what to do rather than use judgement or discretion. This can lead to significant problems in acquisitions where the acquiring company adopts this style but people are used to being told what to do by the centre. Think of all the foreign firms that have had to face this problem in Eastern European countries.
Reporting – Head Office needs to know what is happening in their overseas operations. The extent of detail required and the frequency of reporting will define the degree of trust and control being exercised. As we have already said, Head Office may get what it wants, but this might not be a truthful representation of what is going on. Technology is helping bridge the gap through allowing data to be drawn from local systems rather than pushed up to the centre. This does, however, leave the issue of ensuring that data in systems is reliable which, in emerging markets, is problematic.

Risk monitoring – given the volatility and unpredictability of emerging markets this is one of the most important areas of the risk management framework. Decisions are made on the basis of current information and expectations as to the future, but changes occur which can impact on that decision. Setting and monitoring triggers and carrying out regular reviews are a vital way to test that decisions remain valid. The use of leading indicators, risk triggers, stress testing and scenario modelling are becoming increasingly important and should be encouraged. Monitoring values should be done in-country but head office will normally have a responsibility to ensure that warning signs are not overlooked.

Checks and balances – failure to put in adequate checks and balances has been the cause of many losses not only in emerging markets but also in developed economies. It is of more importance in emerging markets particularly in cultures where deference and respect for authority is deeply engrained. If subordinates are not able to challenge instructions from the boss, even if they know they are not right, then it is important that there are other means to check on abuses or simply errors of judgement. Limiting authority, regular reporting, or tighter controls on the above mentioned elements are ways in which this can be done. Regular internal audits are another way but they are not infallible, as it is not that difficult to fool out-of-town inspectors, particularly where they do not know the local language.

The effectiveness of the risk management framework is often not tested until there is a crisis, but when this happens shortcomings become evident very quickly. Recurring problems that occur are often due to:

- a lack of risk awareness
- failure to appreciate the potential seriousness of deteriorating situations
- not taking appropriate action quickly enough.
Increased investment in people, systems, and tools and techniques for risk management can help protect against this but unfortunately it is difficult to prove a connection between such investment and lower losses. The result is these areas are easy targets when costs become tight. Post crisis, investment goes up, but it is often too late and enthusiasm quickly wanes after a few years of fewer loss events. This was one of the problems highlighted by the Asian crisis. After a decade or more of high growth, many managers had never seen or had forgotten what happened in a downturn, resulting in complacency and under investment in risk management. Given the increase in volatility in such markets in recent times, this lesson needs to be learned and investment in risk maintained at appropriate levels.

**Implementation**

Having decided on the strategy and put in place the appropriate risk management framework it is down to responsible managers, whether locally or in head office to make decisions on a day to day or periodic basis whether to accept, decline or seek to mitigate risks faced by the business. Assessing what is the right course of action can be done using the decision matrix introduced in Chapter 1, reproduced below as Fig 7.3.

![Probability/impact matrix: risk strategies](image)

**Fig 7.3  Probability/impact matrix: risk strategies**

Situations with a high probability of occurring and a high impact must have the highest priority. It would be usual for these to be mitigated or even declined, though the actual choice made will depend on the risk appetite of the decision maker and the potential reward. In the opposite quadrant, it is likely that little or nothing would be done for low probability, low impact...
events. For the remaining quadrants, mitigation is likely to be the most appropriate action but what form that would take would depend on the cost involved and the potential income. For low impact but high probability events it may well be that doing nothing might be appropriate. In reality, much of this type of decision making is done instinctively and using such a matrix in a formal way would be uncommon except for new or complex situations.

This approach can help us make decisions on a variety of individual risks and prioritize the use of scarce resources. A separate question is how can we assess whether our risk management framework is working effectively or not? Consider Fig 7.4. To be effective we need to not only take the right actions, but also be aware of the risks that we are facing. The preferred position, therefore, is to be in the top right hand corner. This may be difficult to achieve throughout an organization, but there may be pockets where this is so, or individuals who are particularly good risk managers. Knowing the risks but not dealing with them may be considered reckless. In the short term this may not matter with good luck but, in the long term, relying on good luck is not a good position to be in as potential risks are more likely to become reality. Being in the bottom left hand corner is clearly unsatisfactory and problems are likely to occur sooner or later. This is almost inevitable if there is ignorance of the risks faced and no attempt to address potential events that are currently unknown.

The goal of senior management is to ensure there is movement within the organization towards the top right hand position. This is not necessarily very
easy, even in developed economies, as a variety of problems may lead to all the various risks associated with a situation not being identified or measured properly. These problems are likely to be much greater in emerging markets, meaning that it is more likely that people will be operating in the bottom left hand portion unless there is adequate foresight and investment in the risk management framework (see section on Managing in ignorance or uncertainty).

A particularly important aspect here is quality of people. Investment in systems and risk models is of little value if there is inadequate investment in people. Managers in all positions, whether it be sales, production or finance, need to understand that they are responsible for managing risk rather than the people with the word risk in their job titles. This is easy to say but difficult to achieve. It is, however, the key to success in volatile environments such as emerging markets. To do this it is necessary to:

- employ good quality people;
- ensure there is a good cultural fit;
- provide regular training on risk;
- expose them to risk – requires stints in audit and investigations or other risk areas as stepping stones to senior management positions. Recycle war stories of losses and expound examples of good risk management;
- ensure reward systems are properly aligned and support appropriate risk taking behaviour, not short term revenue generation.

A typical way this is undertaken in international companies is to move people around on assignments to other group companies or to the head office for short or long periods. This can give invaluable training through exposure to different environments, cultures and sizes of organization, and helps build a network which can be vital when dealing with unfamiliar or unexpected events. This is becoming increasingly common as the pool of talent in emerging markets grows, and people need wider experience within an organization. Keeping people once trained is a challenge that most international companies are continually facing – a key operational risk, therefore, is undue reliance on key individuals.

A last point is that, in most international companies, there will be a combination of local and foreign people in the management team though the mix will vary according to the size and nature of the business, its technical complexity and the degree of local talent available. How well these two groups work together is often an important factor in determining suc-
Cultural conflicts are not uncommon, nor is it uncommon for foreign managers to fail to cope or be effective, as we have mentioned above. As well as seeking to employ Western educated local managers, companies need to put considerable effort into ensuring that they employ the right expatriates to enhance the chances of success. In this regard, Marx suggests that the desirable characteristics of international managers are:

- social competence
- openness to other people’s way of thinking
- cultural adaptation
- professional excellence
- language skills
- flexibility
- ability to manage/work in a team
- self-reliance/independence
- mobility
- ability to deal with stress
- adaptability of family
- patience
- sensitivity.

Getting the right people in the right positions is key when considering risk management, both in terms of minimizing the causes of risk and ensuring inherent risks are managed effectively.

**Tools and techniques**

If managers seek to mitigate risk, how well can they do this in emerging markets? Not as well as developed markets is the answer. This is not surprising, given that a characteristic of many of these economies is that their financial and legal systems are underdeveloped. Consider some of the tools that can be used to mitigate risk.

**Hedging instruments**

*Forward exchange rates* – to hedge risk there needs to be someone with whom to trade. If you want to fix a forward rate for the sale of foreign currency, a bank will only quote if it can lay off the risk. It can do this if there
is an active market, but this is often not the case. In countries with volatile currencies, importers often want to hedge but exporters do not. It is difficult to do a deal in a one sided market.

*Interest rates* – as with quoting forward rates, banks will have difficulty in quoting fixed interest rates unless they can find depositors able to provide matched funds or swapping fixed for floating rates in the absence of developed markets.

*Options* – options allow one way bets to be taken, for a price. Banks will quote prices again on the basis that they can cover the risk somehow, but thin markets make this difficult if not impossible in some emerging markets.

Apart from the size and depth of markets there are other problems to contend with:

- inadequate systems to track and monitor risks
- restrictive regulatory regimes
- inadequate legal framework/infrastructure
- sufficient or adequately trained staff.

Finance managers in companies are often unfamiliar with anything but the simplest products and are unaware of the risks they expose their companies to. More dangerously, they overestimate their skill levels or get greedy after a trade settles in their favour and start speculating. This problem is not restricted to emerging markets but it is easier to do, as more businesses are private owner-entrepreneur run with fewer checks and balances. In Thailand, companies that sold options to banks (giving the banks protection) did not realize that they had left themselves with an open-ended downside risk if rates went against them. When rates moved substantially the wrong way, they were wiped out. Many declined to pay and sued the banks for misrepresentation leading to lengthy disputes, increased costs, and reputational damage but little chance of recovery for the banks.

**Selling or transferring risk**

Like hedging, the ability to sell and transfer risk is not an easy thing to do in emerging markets for similar reasons. In other than a few markets, the prerequisites for using techniques such as securitization just do not exist. These include the means to measure risk, adequate volumes of fairly homogenous
deals, and legal systems that support the practice, not to mention adequate pricing for the risk and investors willing to buy the securitized assets. Some Hong Kong mortgages have been sold off but there are few other examples.

The more common way that risk is being transferred is through equity investments, the sale of part or all of the shares in a business, or the sale of asset portfolios. This later technique has been one way that governments have sought to get rid of failed finance companies’ assets, for instance. Needless to say, these types of deals are being done at a heavy discount to face value reflecting the high risk. This approach has lead to protests and business disruption in several countries and sales have slowed down. This has meant that the government continues to bear the burden of failed enterprises, reducing prospects for recovery of the economy. Indonesia, in particular, has increased the state’s share of GDP through acquiring banks and businesses, but failing to dispose of them quickly enough.

Insurance

Insurance is only of value as a mitigant if the insurer is able and willing to pay out when you make a claim. There is a reasonable prospect that this will happen if you do business with local subsidiaries of foreign insurers, but locally incorporated companies in emerging markets tend to be poorly run and many have insufficient reserves or reinsurance cover to meet high and unexpected claims. Many failed or were closed down during the Asian crisis, while others merged, willingly or under pressure from the authorities or were taken over.

Taking security

This option exists in much the same way as in developed economies, but being able to realize the security in time of need can be problematic due to inadequate or bureaucratic legal systems. In India, court cases routinely go on for years. In Thailand, foreclosure can also be inordinately long. Other countries simply have no laws to allow property to be mortgaged or guarantees to be enforced.

All in all, risk mitigation through these types of methods may be limited due to the lack of basic infrastructure or legal framework to do deals. Another way to seek to mitigate risk is to try and negotiate a better deal. This can run into cultural barriers in countries where a handshake is considered better than a contract. Elsewhere, a signed contract has little meaning and re-negotiation may be feasible, but bargaining is much more a way of life in emerging markets and it may be difficult to improve your
position when dealing with certain nationalities. Even if this is achieved, you may well find any concessions are clawed back somewhere else, maybe without your knowledge.

Where does this leave us? We have the right strategy and have invested wisely in the risk management framework, but we still face a volatile environment where unexpected events can happen quickly, and it is difficult to mitigate known risks. If we rule out quitting the market place, what else can be done to minimize risks in situations where they are unknown, and probabilities are more or less meaningless?

**Managing in ignorance or uncertainty**

If we accept the premise that it is more difficult to identify risk in emerging markets, and that the degree of uncertainty about future events is higher, do we simply do nothing and wait to be hit? In some circumstances, this may be the only option but it is rather a fatalistic and not a very useful approach, so what are the alternatives? To put the question another way, how can we move from the bottom left to the bottom right hand corners of Fig 7.4? There are two ways this can be addressed – try to reduce the level of uncertainty and/or seek to lower the potential impact.

**Reducing uncertainty**

Uncertainty may result from an inability to conceptualize the risks faced. This can only effectively be addressed through heightening people’s level of risk awareness or providing the means by which potential risks, however unlikely, are actually surfaced.

Remember the Titanic – the builders were so blinded by their design that they could not conceive of the circumstances under which the ship could sink. Such blind spots can easily occur amongst business managers, particularly when things are going very well. In emerging markets, it is more likely that something unexpected will occur so it is necessary for management, for example, to take time out and brainstorm possible risks. Helga Drummond in *The Art of Decision Making* puts it very elegantly: “It is always the unexpected that happens. This is not the same, however, as saying that the unexpected happens by chance. The unexpected can happen simply because commonsense styles of thinking blind us to less obvious possibilities.”

If possible risks are on the map, there is at least some prospect that some defensive action might be triggered, because it is not the events that fall within the 99 per cent range of a normal distribution which cause companies problems but the “one in a hundred year events”. One way to address
this is to get an outside independent view to validate the business strategy and the tactical plans put in place to make it work. This was the way that many companies tackled the Millennium Bug to try to rationalize and make manageable an almost impossible range of risks. Consider the following.

**Intersecting risks**

An example may help conceptualize the complexity of understanding how risks are interlinked and how difficult it can be to follow potential events.

If you stand by a pond and throw in a single stone, the ripples flow out from the point at which the stone entered the water. It is easy to follow the ripples as they slowly lessen in height and disappear.

What happens if you throw a second stone close to the first one soon afterwards? The ripples overlap and the patterns become confused.

If you throw a handful of stones there are many ripples which quickly intersect and produce a confused pattern which it is impossible to follow.

To start to try to understand the possible impacts of the Millennium Bug was like following the complex web of ripples caused by throwing a handful of stones into a pond. By building models and thinking through relationships it was possible to reduce the number of scenarios and focus on the key events. This is what needs to be done in emerging markets. Open up the thought process so no wild ideas are overlooked and then narrow them back down to manageable events. Putting this into practice in some cultures can be difficult, particularly where bad news is not liked or situations where the boss is expected to know everything. Ways need to be found to overcome such problems by use of one on one sessions, outside facilitators, or by contracting out the process completely.

There is another angle to uncertainty which is that possible events may be known, but assessing the probability of them happening is hard to determine. In reality, unless the risk area we are studying lends itself to precise mathematics e.g. market risk, our ability to attach probabilities to events is generally very poor. Even then our measures are vulnerable to model risk. The only approach in these circumstances is to use judgement, and rate an event either so unlikely that it is not even worth considering or believe it is possible and adopt a cautious approach i.e. rule it out completely or attach a higher probability of it occurring than you might otherwise.
Other ways of addressing uncertainty include:

Improving your radar – if you do not know what is going to happen then at least try to get an early warning of it occurring. This can be done through thinking carefully about what your critical success factors are and building a series of risk triggers or leading indicators linked to those critical success factors. Scenario planning and stress testing are good ways of doing this. Developing and refining new tools and techniques is another.

If you are vulnerable to higher interest rates it is a simple matter to follow interest rate movements. Companies that got into trouble in the Asian crisis did so when interest rates shot up or where, when they were borrowing in dollars, there were sharp devaluations. In hindsight, the warning signs were there of potential devaluations – increasing budget deficits, trade deficits, decreasing international competitiveness as the dollar strengthened, etc. If these factors, which are one or more steps removed from the event that will affect you, had been tracked, the currency crisis and higher interest rates would not have been so surprising. Managers that excel in this regard see trends and problems early, and can reduce their risks by passing them on to others who are blind to the changed level of risk.

Influencing – a common cause of uncertainty in emerging markets is unexpected changes in regulations. One way to protect against this is to form close relationships with the regulators, and to lobby for changes that are favourable to you, lobby against things which will adversely affect you, or seek to be party to the drafting phases so that any change is comprehensible and workable. Foreign companies, or well connected local partners, are often able to lobby effectively, especially where their business is important for the local economy.

The final option is, of course:

Avoidance – if, for example, the proposed site for your factory is near a volcano that has not erupted for 50 years, would you set up business there? Probably not, as there is always a chance that it could blow and though this might be unlikely there is nothing to say that it would not occur tomorrow. One of the problems with probabilities is they say nothing about timing.

A common theme with all the above points is being creative and thinking out of the box, unlike the Titanic builders. Phillip Hodgson and Randall White in their book Relax – It’s only uncertainty discuss this at length and provide a number of useful pointers in how to deal with uncertainty which could be applied in emerging markets.
Minimizing the impact

Whether or not you have done any of the above it always makes sense to protect yourself against the impact of adverse events. One factor important to consider is that it is not the source of uncertainty which is necessarily the problem, but the impact it has on your business. There may be several causes of a problem – systems down, no telephones, a strike, natural disaster – but the impact can be the same – disrupted customer service – and the actions necessary to address this are likely to be the same or very similar. Think of our call centre, the problem is that you cannot deal with customer calls. The question is, how do you get customer service up and running while the underlying problem is dealt with? Ways that this can be done include:

Invest – if you are dependent on uninterrupted power supplies it makes sense to put in generators or other means to keep the power on. It may be that existing resources could only cope with a four hour interruption, but it is not inconceivable that one could last for a longer time, so putting in place additional generators should be considered. Over-resourcing or over-staffing are common approaches to potential problems in emerging markets, but sometimes even that is not enough!

Ensure that contingency plans are in place and they work – an inability to conceptualize disasters is a common failing. Ask any manager what he would do if the building he worked it was put out of action by fire, bomb blast or other natural catastrophe, and many would be unable to answer you. Robust contingency plans that have been tried and tested will reduce immeasurably the impact of any such disaster.

Vandals put millions in the dark

Vandals damaging a power line were blamed for causing a blackout that will leave eastern Nigeria without electricity for two weeks.

Thirteen of Nigeria’s 36 states – and tens of millions of people – are affected by the power failure.

A businessman said, “There is nothing we can do. Even those who can afford generators can’t find petrol to put in them”.

Extract from the Daily Telegraph, Friday 8 June 2001

Ensure that contingency plans are in place and they work – an inability to conceptualize disasters is a common failing. Ask any manager what he would do if the building he worked it was put out of action by fire, bomb blast or other natural catastrophe, and many would be unable to answer you. Robust contingency plans that have been tried and tested will reduce immeasurably the impact of any such disaster.
Train managers in crisis management – being put on the spot by a reporter about an incident that you know nothing about is one of the worst scenarios a manager can face. If he has received media training, e.g. he understands the art of not answering, and knows what to do because he has a crisis management manual to hand, then there is a better chance of damage limitation succeeding, and the problem blowing over without creating reputational risk.

Offset risks internally – large multinationals can offset risks within their operations. If one area has a production problem it can switch orders elsewhere or divert output to meet urgent orders. Similarly, many such companies can hedge risks internally through a global treasury rather than doing it externally with a bank.

As we have said, it is not uncommon for there to be problems that disrupt business in emerging markets. The upside is, because problems occur more often, managers are likely to be well versed in dealing with such events so they are less of an issue than in developed economies. In addition, customers understand local problems and their expectations will be lower. This was one reason why the Millennium Bug was generally played down in Africa as service disruption has been a common occurrence for many years there. Problems occur when companies in emerging markets have to operate to developed market schedules and standards where tolerance factors are that much lower (call centres servicing global clients).

Risk and reward

It is all very well talking about risk management and propounding ideas on how to minimize risks, but we must not forget that most, if not all, of the ways in which this can be done cost money. Getting the balance right between risk and reward is important, but it is a difficult area, as it is not easy to prove that investments in risk management actually deliver benefits. Consider the following.

If you spend money on an advertising campaign and sales go up by 50 per cent, you can reasonably conclude that there is a link between the two events – higher advertising means more sales. If you spend USD 1,000 on insurance and make USD 2,000 of claims, you would think that it was money well spent. Investment in risk mitigation paid off.

Adequate reward?
The point of these examples is that it is usually easier to see the benefits on the revenue side. If management is driven by the need to deliver good bottom line numbers, then it is easy to focus on cutting costs in the risk management area. This could actually have longer term disastrous consequences if this means you forgo downside protection at a time when the associated risk has not changed, or maybe it has even increased. Beware complacency – a ten year record of no claims does not mean there might not be the need to make one tomorrow.

One way to consider this dilemma is to use the diagram set out in Fig 4.2 (reproduced as Fig 7.5). Taking risk (on the left hand side) earns revenue but this needs to be balanced by investment in risk management (the right hand side). Launching a new product, for example, is risky. Before and after launch there needs to be ways to assess and mitigate the risk. Beforehand this is often done by piloting the product or test marketing it. Risk is reduced in this way by limiting the size of the initial investment and only launching if there is positive feedback. After launch, there will be close monitoring of sales, customer feedback surveys, or other means used to ensure that the marketers got it right. Once the product is safely launched,
this investment can be scaled back. In this way the launch risk (an external event) is balanced by investments in risk mitigation (internal). As risk reduces, the need for risk mitigation will recede.

As with all balancing acts, keeping things on the level, can be a tricky process. This will be more difficult in emerging markets because of their volatile and unpredictable nature. The key requirements for doing this in such potentially volatile environments are:

- **Having the right strategy** – make sure your strategy is the correct one, taking into account all the potential, as well as unexpected risks, and confirm that the level of reward is commensurate with the risk, both in the short term and in the long term.

- **Investing in risk management** – ensure that you have the risk management framework appropriate to the strategy and environment you are operating in, and that an adequate level of resources is invested in making it work.

- **Being flexible** – continual readjustment of tactics and reallocation of resources is necessary in almost any business operation, but things can change more rapidly in emerging markets and have more devastating impacts. Management needs to be aware when changes in risk occur and take action, which might include abandonment of the current strategy.

Businesses are attracted to emerging markets because the perceived level of rewards are high for one or more of the following reasons – growing markets, higher margins, lower costs, low product development costs. Such rewards, however, can only be earned at a cost, which needs to be factored into the equation. The country manager of Unilever’s operations in Colombia explained this very well.

**The cost of doing business**

Colombia has a reputation as being a dangerous place to operate, but it is a sizeable market with a reasonably high per capita income, making it an attractive country to do business in. Unilever sells a range of consumer products including many household brand names such as soaps, detergents and ice cream. These sell in supermarkets and corner stores.
To achieve a good market position requires adequate shelf space and countrywide distribution. Moving goods around, however, can be dangerous, particularly in certain parts of the country. The company faces the risk of loss or damage to its trucks, cargo, and injury or worse to its staff. How is this addressed?

It is dealt with through a rational assessment of the risks and the assignment of appropriate resources to risk mitigation. In major urban areas, the risks are low, so frequent small deliveries with low-level security can operate safely. For more distant or dangerous areas, deliveries are undertaken only during daytime accompanied by armed guards. In some cases, trucks travel only in convoy. Over time, the level of perceived risk may change and adjustments are made to these arrangements.

All of this increases distribution costs but through rational decision making, these are kept to a minimum. The costs are factored into prices and competitors face the same challenges. Security is not a competitive issue.

This case study clearly shows the approach that needs to be adopted to be successful in emerging markets – rational risk assessment and flexibility, plus appropriate pricing to cover the costs. If this can work in Colombia, there is no reason why it cannot work elsewhere.

What lessons does all this give us for our case studies?

Call centre – the main risk issues for a call centre manager are operational risks, people, technology and premises. These will be addressed largely through the use of Western technology standards and putting in place back-ups and maybe back-ups to back-ups to ensure continuity. The main problems are likely to come from the people side. Attracting people is unlikely to be a problem but keeping them, if there are competitors coming in, may be an issue, as might be avoiding cultural problems such as conflicts with religious beliefs. One of the main ways these issues can be managed, is through having local managers who can bridge the gap – people who understand Western requirements and local issues. Finding the right people and then retaining them is one of the key risks management face.

Construction contract – contract managers running large contracts in emerging markets must deal with all sorts of risk issues daily. These risks can be broken down into those that impact directly on the physical completion of the contract, and those that impact on the financial aspects. Managing
the physical aspects can involve many issues from adequately trained staff, to health and safety, to finding that the physical conditions of the ground are not what was expected. These will need to be managed through the project management process, but with tact given potential cultural sensitivities and the need to manage client relations. Managing a stream of sub-contractors can also be problematic but can be done with clear and consistent communication and making promises that are kept. We have already touched on potential financial problems which are more than likely to arise. If only one person is permitted to sign the progress payment cheque, and he is away on official business, there is little that can be done but postpone payments and/or seek funds from Head Office or bankers to cover the shortfall. Exchange and interest rate risks should be covered as far as possible, given any local market limitations.

Manufacturer – constructing the premises is likely to be a logistical nightmare involving umpteen approvals which can only be done with patience or appropriate “help”. Prepare for delays. As a rule of thumb, double the initial time-frame expected to get anything up and running and you are not likely to be far off. Once running, the problems will be ensuring that production keeps going – at the levels you expect, that staff are not pilfering undue quantities of whatever is being produced, and that no one has stolen your product designs and set up a rival factory close by. Distributing produce, selling it, and then getting paid are more exacting in emerging markets than at home due to different norms and values. Credit risk will be difficult to assess and manage, other than keeping unsecured credit very low.

**Conclusion**

We have dwelt on the nature of emerging markets and sought to show that understanding risk must be treated differently in such environments because:

- emerging markets are different from developed economies and this gives rise to new risks;
- risks, which have a low probability of occurring in developed countries, have a higher likelihood of occurring in emerging markets;
- risk management is more problematic because identifying and measuring risk can be more difficult and some of the techniques used to manage risk may not be available, or work as effectively as they do in developed countries.
This means that there is a wider range of risks that may occur, totally unexpected events are more likely to happen, and there is greater volatility. Political and economic instability is both the cause and result of higher risk. Cultural and language difference add another powerful ingredient to the cauldron.

All is not bad news, however, as many companies have and will continue to be successful in emerging markets. The most successful companies are those that have learned to adapt to or been able to change the riskiness of the environments they operate in – large companies in small markets can exert significant influence. In addition, levels of return can be sufficient to cover the increased risks, but such levels of return can be fragile. Understanding this fragility and preparing for unexpected risks will increase the probability that long term objectives will be achieved. For those just entering the market place it is important to learn from others’ mistakes to ensure that disasters are avoided – forewarned is forearmed. Unfortunately there are too many examples of companies entering the unknown without proper due diligence, and operating on the premise that events will unfold exactly in line with the assumptions they have built into their strategic plans. This is particularly so in competitive bidding situations such as construction contracts where reality rarely accords with expectations. Additional costs and delays in payment are common and can wipe out expected profits very quickly.

To succeed in emerging markets some important things to do are:

- **Find out what it is really like** – thorough due diligence will pay dividends. Use independent experts who can give impartial views and highlight those risk issues that a Head Office team are unlikely to find such as corruption, security concerns, political stability, etc;

- **Ensure that your strategy is appropriate** – is it the right market, the right time and the right way to enter? A structured approach which fits with group strategy is more likely to succeed than an opportunistic investment;

- **Do not underestimate cultural issues** – any investment which does not take due account of culture is likely to flounder. Make sure that these issues are understood, not only on the ground but also in Head Office, and that people are aware of their own prejudices;

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For those just entering the market place it is important to learn from others' mistakes to ensure that disasters are avoided – forewarned is forearmed.
• *Take a long term view* – like investing on the stock markets, best returns are likely to be made by taking long term decisions and avoiding over-reaction to short term volatilities;

• *Employ good people* – it makes a great difference to have people who can effectively bridge the gap between developed and emerging markets. Having technical knowledge does not mean that someone can pass on knowledge, or manage effectively in a totally different environment;

• *Remember emerging markets are not all the same* – it is different doing business in China than India so experiences gained in one market may not work well in other emerging markets;

• *Price adequately for the risks that you take* – make sure there is an adequate margin to cover those unexpected risks as well as to pay for the risks that are known to you;

• *Consider your exit strategy* – think about what your stance would be if it all went wrong? Could you afford to lose all your investment? If not, it may be better to reconsider and not bet the company on an investment with high risk, even if the rewards are quite enticing.

Finally, do not forget that risk is not always about the downside. Unexpected change can produce circumstances which will benefit your business. Investing in emerging markets need not mean lots of sleepless nights.

**Summary**

• Actual or potential risks in emerging markets are higher than developed economies due to a variety of physical, political, economic and social factors which lead to enhanced volatility and uncertainty.

• There is likely to be quite a wide cultural disparity between your home and an emerging market location.

• Identifying risks can be problematic, but even where risks are obvious, determining what could happen and when, remains difficult.

• Political and economic changes, particularly since the Asian crisis, are increasing the potential levels of risk in some areas and making them more difficult to predict.
Emerging markets and risk management

- Measuring risk in emerging markets is problematic but not impossible. Quality and quantity is improving but not as fast as some would wish.
- The first step in managing risk is ensuring the right strategy is pursued.
- Ensuring a robust risk management framework is a vital ingredient in dealing with the increased level of risk in emerging markets.
- Tools and techniques for mitigating risk are often not as effective in emerging markets.
- Despite the uncertainty over possible future risk events, there are ways and means of influencing this or minimizing the potential impact should adverse risk events occur.
- Risk can be successfully managed in emerging markets through rational risk assessment and flexibility.

References


PART THREE

The future of risk management
“Looking ahead, the risks that we face are increasing in scale and complexity. Unfortunately our ability to respond has not kept pace” MARK HAYNES DANIELL

CHAPTER 8
Trends and developments in risk management

Introduction

The world is not static but changing rapidly and at a seemingly ever-increasing pace. This creates new opportunities and challenges but also risk and uncertainty, not least in emerging markets.

So far we have looked at risk, what risk management means, described the nature of emerging markets, and brought these together in looking at risk and how it can be managed in emerging markets. Now we must look forward and consider how risk might evolve and what managers will need to do to respond effectively.

The basic premise is that the level of risk in emerging markets will continue to increase. Government policies to open up their economies, without always putting solid foundations in place, have made them more vulnerable at a time when significant change is occurring. What seemed the right thing to do during the golden years of the Asian miracle no longer seem so beneficial. This means that risk management needs a different approach in emerging markets because of the greater volatility and uncertainty that is now evident. Unfortunately, we cannot predict the future so we must act smarter and take more care to prepare for unexpected events that will occur.

Before looking forward let us consider the recent past.
The changing face of risk

In Chapter 1 we gave a very short introduction to the nature of risk. Before modern times, people led simple lives and many never ventured far from where they were born. Their lives were not free of risk, however, even if the word was not one that they would have been familiar with. The risks they faced related largely to survival and included wars overrunning their homes, adverse weather wiping out their crops, or disease threatening their lives. These risks were largely outside their control and they trusted in God to protect them. Over the years, towns and cities grew in size, commerce expanded, international trade blossomed and new means of transport were developed along with new methods of communicating. This meant life became more complicated and new, man–made, risks were created. Along with these new risks came the ability to influence them.

Today life is very different – we live in a world where we have virtually instantaneous global communications capability, powerful computing capabilities on our desks and the ability to search for and retrieve vast amounts of information through the Internet. We are bombarded with junk mail but can jet away to exotic locations if the fancy takes us.

The following example illustrates one aspect of how our lives have changed.

A sign of the times

To see just how much life has changed and how interconnected we now are, take a quick look in your local supermarket.

Today there is an almost bewildering array of products on offer, not just sugar or bread but umpteen varieties of them, along with many types of exotic fruits and vegetables that we had hardly heard of five or ten years ago.

Looking for your favourite fruit and veg? You can now find them all year round, as there are no longer seasons when vegetables are not available. Somewhere in the world a crop can be produced and transport costs have dropped to the point that they can be air freighted in at an acceptable cost.

Thirsty? Just look at the Coke section in the drinks aisle – original Coke, Classic Coke, Diet Coke, caffeine-free Coke, caffeine-free Diet Coke, Cherry Coke, etc, etc. For the first 50 years there was only one Coke. Now there are many types not to mention hundreds of other competitors and imitations.
All of this change means that the nature of risk has also changed. Increased interconnectedness means more dependencies. Increased dependency means that new types of risk are introduced and existing ones change. Linkages between the different types of risk become more important. This means that it becomes more difficult to spot potential risks or assign probabilities to known risks. A downturn in retail sales in the US causes unemployment in Malaysia, exchange rate crises in Latin America cause knock on effects in Asia, a downturn in the Nikkei Index impacts the Indonesian stock market, oil price changes impact everyone and so it goes on.

This increase in interconnectedness means that the impact of disruption rises disproportionately. What would we do without power, petrol or water? Even short term interruptions of more than a few hours can be uncomfortable but what if they are longer? In the late nineties in Auckland, New Zealand, severe power failure left people without electricity for weeks. The result was chaos and near anarchy.

For businesses the new environment is more complicated and changes more quickly. New products and ideas have a much shorter shelf life that means making the right decisions is more critical. Having a killer product today is no longer a guarantee that you will be in business in 24 months, let alone 12.

In America in the late nineties, first Chrysler and then Ford and General Motors invested heavily in all-purpose utility vehicles (SUVs) that became very popular. An increasing proportion of sales and an even higher proportion of profits originated from this market segment.

In 2001, all these companies are looking, at best, at lower market shares and sharply lower profits because competitors have caught up and overtaken them with better models and cheaper prices.

Currently, there are an estimated 47 models from several suppliers in this one market segment alone. This is a sharp increase from the dozen or fewer models that the three main players provided less than two years ago.

A cash cow has been turned into a potential dog in a short time-frame!

With all this risk around, how has risk management responded?
The rise and rise of risk management

In Chapter 1 we mentioned that the word risk is a relatively new term and that the tools and techniques of risk management, or at least the quantitative side of it, were derived largely from the needs of the insurance industry. As the complexity of the economy has increased and new risks have emerged, usage of the term risk has become more common, so much so that it is now part of everyday language. It did, however, take a long time to reach the current stage of development. This is due to the fact that, despite two world wars, the economic environment in which most economies operated was fairly benign until the last 20–30 years. This has all changed. The following are some of the events that have influenced people’s perceptions of the world and the levels of risk:

- OPEC oil price hikes in the early seventies;
- the demise of the Bretton Woods agreement and end of fixed exchange rates;
- the overthrow and exile of the Shah of Iran;
- the LDC debt crisis and the realization that countries could default;
- the savings and loan debacle in the US;
- privatization and deregulation of utility and transport companies which exposed cosy monopolies to market forces;
- development of the Green movement and environmental lobbies;
- the phenomenal growth in corporate litigation.

For a good description of these historical developments see Ben Hunt’s article in Mastering Risk (2000).

All of these, and many other events, have exposed companies to risks they had either not faced before or had not considered important. To address these new risks, new ways needed to be found to identify, measure and manage them. The result has been the emergence of the professional risk manager. It was initially a slow process as risk management techniques developed and spread from the insurance industry throughout financial services into manufacturing and service companies. The areas that developed the fastest were those that were easily measurable and which could be modelled – credit risk and market risk. More recently, interest has grown in trying to measure and model operational risk. A more fundamental transition has been the change in the role of risk management from one of simply
protecting downside risks (loss prevention), through
insuring physical assets or hedging financial expo-
sures, to more forward looking participants in
business decisions (business partners). Risk manage-
ment areas in business are now becoming internal
consultancies and not simply backstops.

Today there is more talk about enterprise wide risk management and
the need for a more holistic approach to risk. Risk management units are
now fairly widespread and there is an increasing literature on the subject.
Many more people across a wide range of industries now have the word
risk in their job titles, whereas until the late eighties this was uncommon
outside the insurance sector. At senior management levels, an increasing
number of companies have a Chief Risk Officer. All these changes are pos-
itive developments but care is needed as it is not the risk professionals who
are responsible for managing risk but line managers. The risk professionals
are responsible for the risk framework and ensuring that risk is managed
effectively – they are more groundsmen and referees rather than players,
to use a sporting analogy. This is a critical distinction because line man-
gers need to know more about risk and take ownership for dealing with
it than they did in the past. This is particularly true in emerging markets
where new twists turn up almost daily.

All in all what we have seen is an explosion in the attention being paid
to risk but given the rapid changes which are occurring and the increased
inter-connectedness of the world, is it enough? Mark Haynes Daniell in his
book *World of Risk* suggests it is not. He defines the net at risk position to
be determined by four elements. On the minus side we have:

the size of impact of a risk event *adjusted by* the likelihood of the
event occurring.

While on the plus side we have:

the ability to respond *adjusted by* the likelihood of that response
being effective.

Figure 8.1 represents this diagrammatically. For any situation, X, the net at
risk position can be improved if actions are taken to enhance the ability to
respond and/or increase the likelihood that the response will be effective.
Such actions could move X in any of the directions indicated by the arrows.
Failure to do so would see the net at risk position deteriorate.
Daniell's view is that the movement in the net at risk position is towards the top right not towards the preferred position in the bottom left. This is because the potential size of risk events is increasing, as is the likelihood that they will occur. Conversely, the ability of companies and governements to respond is not increasing at a corresponding pace because a number of risk events are international in scope and getting co-operation and funding to address them is difficult. In addition, solutions which work at a country level may increase rather than decrease cross-border risks. These factors mean that the likelihood of any response being effective is diminished.

The following examples illustrate typical problems that have emerged in the past few years that support this line of argument:

- understanding and dealing with AIDS
- addressing environmental issues
- dealing with the causes and effects of regional conflicts
- drugs
- money laundering.

In these and other cases, recognizing the problem in the first place has been a struggle, let alone finding acceptable solutions that can be made to work.

Emerging market economies are impacted by all the above as well as many more potential risk events, but should we be concerned? In terms of Daniell's net at risk calculation the answer is yes, because the potential impact of these events is increasing and recent history suggests that risk events are more likely to occur now than previously. Events since the Asian crisis also suggest that
the ability of governments to respond at all or, if they do respond, for that response to be effective, is questionable. Many promises have been made and have not been delivered on. Others have floundered for one reason or another. Even where changes have been made they have not always had the impact that was intended e.g. Thailand introducing bankruptcy laws but not having sufficient experienced people to implement them. On the global level trade negotiations continue but make slow progress as does agreement on how to address environmental concerns.

A prime reason for some of the current problems is that emerging markets have opened up their economies to trade and competition without always understanding the consequences of what this means, or putting in place the necessary foundations. When the foundations have been tested and found wanting, governments have been unable to effectively deal with this due to political or economic constraints.

Companies can do little to influence these macroeconomic or political events but they do need to try and understand them and position themselves accordingly. Before considering the future direction of risk management, let us consider in more detail the current drivers of change.

**Drivers of change**

There are a number of factors that have been driving change. We have mentioned many already. The key ones are worth repeating.

**Technology** – this has been a great boon in many ways but has created dependencies that make processes and people vulnerable to interruption. Computing, communications, transport, manufacturing, etc, have all been revolutionized but a failure at one point in the process can have serious knock on effects elsewhere.

**Credit** – previous generations saved up till they could afford something. Today we are bombarded with offers to borrow virtually daily. Easy credit has fuelled the growth of a consumer society where fashions change rapidly. People’s expectations have been raised and credit has provided the means to fulfil them. Consumer electronics, for example, has boomed as a result but the boundaries between functionality and fashion have become blurred in the process. Take mobile phones, they are now as much fashion accessories as means of communication. New models are “must haves” today, only to be discarded in a few months’ time.
Deregulation/privatization – governments have, in many countries, got out of the business of running utilities by opening up markets and/or selling off their shareholdings. Increased competition has benefited consumers but not universally so, and in some areas letting go has proven difficult – national airlines still proliferate even where there is no economic justification.

Regulatory intrusion – it may seem strange to highlight increased regulatory pressure after citing deregulation as a driver of change. There is clearly a paradox that on the one hand industries are being deregulated, but on the other management is becoming more hemmed in by new regulatory requirements. In part, this is a reaction to deregulation – governments may no longer own the utilities and transport systems but they retain some responsibility and are concerned that private monopolies do not simply supplant public ones. They do this by putting in place new regulatory bodies that control prices, service quality, and other aspects of what the newly privatized businesses can do. In addition, new requirements have been placed on boards of companies either through legislation or “guidelines”. In the late nineties in the UK, the Turnbull committee recommendations, that all listed companies are now required to follow, included the requirement that boards:

“... should manage business risks in their entirety, and should review on a regular basis the effectiveness of risk evaluation and control processes.”

This illustrates quite clearly how the scope of risk management has evolved as the earlier Cadbury requirements, which Turnbull replaced, defined risk management responsibilities much more narrowly in terms of financial risks only. This change, and particularly the need for regular, rather than simply once a year reviews has led to a significant increase in the need for risk management systems, controls and reporting on their efficiency.

Economic unions/free trade areas – the breaking down of trade barriers, such as the North American Free Trade Area (NAFTA), or more pervasive economic integrations, such as the European Union, have created vast areas within which the movement of goods can occur much more easily. China’s entry into the World Trade Organization will create significant change in that country which will have ripple effects throughout its Asian neighbours. Looking forward, what further developments could happen? An Asian Free Trade Area, economic union, or single currency? Greater co-operation in the economic sphere is already happening, but where will it lead?
The internet – perhaps one of the most important developments in recent years has been the Internet. Virtually unheard of ten years ago, it has brought information to users’ fingertips that was totally inaccessible previously. It has been used to build some businesses and undermine others. It has shrunk the world and made controls on the national press by repressive regimes virtually redundant. Few have made money from it though, and many have lost millions. It has introduced new risks – viruses, hacking, cyber fraud and cyber attacks.

Currency movements – exchanging money and moving it across borders is a function bankers have fulfilled for centuries. Until recently such movements were linked to the underlying movement of real goods, international trade, or the making of investment overseas. Much of this was controlled by central banks and tightly regulated. Today, the volume of currency deals done daily (USD 1.5 trillion and rising) exceeds the total volume of trade done annually and the gap is growing. Capital controls have been abolished in most countries and so called “hot money” moves in significant amounts rapidly. Movements into and out of emerging market countries can impact stock market prices and move currency rates. When sentiment goes against a currency it can go into a tailspin quite quickly. In practice, the majority of emerging market’s currency rates only ever go one way (downwards) against the USD, the currency of international trade, over the long term. The problem is that it is never easy to predict how fast. Currency movements tend to be irregular and volatile, rather than smooth and predictable.

Ethics – in the past few years there has been much more discussion and interest in what impact companies have on the environment. This started out with a narrow focus on pollution of the environment but has since broadened out to include:

- sourcing raw materials
- labour practices of suppliers
- dealings with countries with questionable human rights
- the use of modified food products
- use of animals for product testing.
Annual general meetings have become minefields for company chairmen when faced with activist shareholders or protestors. Reputational risk has definitely moved up the agenda, and issues such as protecting brand value feature more highly in strategic and tactical decision making.

These drivers contribute to global instability and have led management to think more seriously about the need to anticipate risks more effectively. Many household names have disappeared through failure to anticipate risks. Some have been taken over, others have closed. In the financial world alone, international names such as Midland Bank, Manufacturers Hanover Trust, Security Pacific and Barings have all disappeared in the past decade. To protect against this, boards of directors are seeking greater comfort that the wave of extreme events that seem to be occurring more and more frequently do not catch them out.

All of the above have and continue to impact on emerging markets to a greater or lesser degree. Many of these factors are having more dramatic effects on those economies because they are smaller and more vulnerable. The result is a rapidly changing emerging market landscape, that in turn is increasing the need for a better understanding of risk in those countries and in the global economy as a whole. Let us consider this in a bit more detail.

The impact of change in emerging markets

The various changes listed above have changed the nature of emerging markets. How they have responded has, in some cases, increased the impact of that change. Some of the changes that have occurred specifically in emerging markets are:

*More open economies* – governments have changed direction and opened their economies as a means of joining the growth bandwagon. Countries such as Turkey, that had been very insular, sat behind tariff barriers in the sixties and seventies but then opened up in the eighties and sought to boost GDP through an export led growth strategy. For countries to succeed they need to have one or more competitive advantages. The biggest advantage that most countries have been able to offer is cheap labour, but this is no longer a guarantee of success because:

* higher growth rates tend to lead to rising labour costs as standards of living increase and governments outlaw unfavourable labour practices;
other countries are opening themselves up and offering even cheaper labour rates;

rapid movements in exchange rates mean a country's competitiveness can increase or decrease very quickly.

The result is that today's world is increasingly competitive. To stay competitive, countries need to look for higher valued added activities. Singapore is encouraging high-tech industries to move there, and Hong Kong has become a service economy now that most manufacturing has moved to China, where costs are significantly lower.

Post Asian crisis countries' competitiveness is changing rapidly in line with the relative devaluation of its currency against those of its main competitors vis-à-vis the USD. Nike, as we have explained, places orders with companies in the country with the lowest cost, provided quality and delivery times are the same. One month those orders may go to one country but the next month to a completely different one. Trade becomes a bit of a lottery or, at least, a high stakes game. Thailand, for instance, has suffered from the opening up of Vietnam as a low cost country but, so far, can beat it on quality. That will undoubtedly change.

Increased inward investment – as economies open up, the level of investment in emerging markets has increased substantially, especially in export type businesses. Multinationals have built new factories from scratch or taken over and modernized existing, and often underperforming, local enterprises. These investments have brought increased wealth and better standards of living to some areas and skill levels have increased as a result of the transfer of technology and know how. In recent years, the emphasis has changed in some countries. Investments have increasingly been aimed at sales in-country as local economies have developed, manufacturing costs have risen, and incentives to exporters cut back. Key investors in the past decade have come from the service sectors, restaurant businesses, insurance companies and banks to name but a few.

Jumping generations – while initially emerging markets were largely seen as sources of cheap labour churning out exports, they are now attractive markets and factories are being built with leading edge technology. In some areas such as communications, greater use is being made of wireless phone technology and satellites than in the West. Today it is far easier for countries which are behind to update to the latest technology. Computers are replacing paper without going through an intermediary mechanized stage that occurred in Europe and the US.
Vulnerability to financial flows – while increased inward investment in tangible assets has generally been a positive influence on emerging markets, two other developments have not – corporate borrowings in foreign currency and investors looking for high returns in emerging market stocks. One of the major causes of the Asian crisis was the increased level of borrowings that local companies had built up in US Dollars and other currencies, when they did not have foreign currency sources of income. When local currencies crashed, companies were wiped out. One of the causes of these problems was, supposedly, speculation against those currencies, not helped by investors bailing out of the local stock markets and taking their proceeds home. Such outward movement of funds led to overcorrection – a normal tendency of markets – leaving the local central bank/government with a financial crisis to deal with. Gill Tudor’s book Rollercoaster provides a fascinating blow by blow account of how such factors led to various emerging market crises during the nineties. One of her key contentions is that the Mexican crisis in 1995 was dealt with relatively quickly and painlessly, which encouraged investors to pile more deeply into emerging markets. This accelerated investment, particularly hot money, which sowed the seeds for the much bigger and long lasting Asian crisis a few years later.

Changed expectations – people in emerging markets have been more and more exposed to Western influences as a result of the increase in travel to and from these countries, the growth of satellite TV, more people being educated at Western universities and colleges, and the information flows coming from the Internet. The result is heightened awareness of how other people live and a desire to have similar lifestyles. People are no longer satisfied for companies to close down plants in the West and ship them to emerging markets to meet local needs. No longer will they accept that the national car in India be a 1950’s design largely unchanged for four decades. This creates opportunities for companies supplying products associated with those lifestyles, but dissatisfaction for those who cannot afford them. It is all very well McDonald’s opening up in town and providing jobs for a few, but when a Big Mac costs a day's wage for the average worker, he will either forgo other necessities or feel resentment that he cannot afford a burger.

Addressing the fundamentals – today government leaders have generally accepted that there is a need to put in place the important building blocks that are associated with developed countries. Things such as:
• an adequate legal framework and a sound judiciary;
• better accounting standards;
• greater transparency;
• increased accountability;
• bond and stock markets that can provide the necessary finance for companies to grow;
• a fully functioning democratic process.

However, they are not all committed to getting these things in place as self interest and cronyism, as well as public opinion, get in the way all too often, especially as elections approach.

Unrest – when things were going well in Asia there was little dissent. Come the downturn companies closed down or laid off workers. The result was both violent and non-violent protests. These were seen in many countries, Korea and Indonesia being amongst the most prominent. Such problems were not confined to Asia however with unrest seen in India, Turkey, Russia, Zimbabwe, Colombia and Venezuela to name but a few. Government leaders have been toppled by popular uprisings and though this is not new, Marcos remember was ousted by people power in the late eighties, heightened expectations and greater economic vulnerability is making this a more likely scenario.

Considering just these few factors we can see that much change has occurred in emerging markets. Much of that change has occurred in the past five years. The pace of change is also accelerating. More importantly the changes are largely irreversible.

So where to next?

The future?

If you had written down ten years ago what you expected the future to look like today how close would you have been to current reality? Would you have predicted the internet and the explosion of e-mail, that so many people would own a mobile phone, that your phone call to a hot line in the US would be answered by a call centre worker in India, that laser surgery is doing away with the need for glasses or that we would be able to clone animals? Probably not. Others have tried and published their predic-
tions. Revisit the works of noted futurologists such as Alvin Toffler and John Naisbitt and see which of their predictions have come true. Just as important which did not – are we any nearer the cashless society? How about the paperless one?

Such a review will make it clear to us that we are not very good at predicting the future, even six months ahead in some cases. It is easy to suggest that the world will be quite different in many respects ten years from now but determining what that world would look like is quite difficult. The reason this is important is that unidentified risks are difficult to manage. A lack of imagination or failing to think the unthinkable will leave you unprepared when that unexpected risk event does occur. In emerging markets it is more or less inevitable that something unexpected will happen today, tomorrow or next week.

While we cannot see forward in time with great accuracy, there are a number of trends that we can be reasonably confident will continue.

Continuing globalization – McDonald’s golden arches are one of the most obvious signs of globalization. There are many other examples of brands that are well known globally – Nike, Coca-Cola, Citibank, Nestlé, etc. Globalization makes national boundaries less relevant and undermines the ability to develop effective risk management solutions at country level. Protest against globalization both in development and emerging markets are impacting existing and proposed investment decisions and increasing risk.

Increased complexity – globalization is not only about the development of worldwide brands but also increased connectivity. Companies that sell Nike shoes in the US source them from any one of a dozen countries in Asia, Latin America or elsewhere. Those manufacturing companies may source component parts from several different countries. Shoes must be manufactured and shipped in time to meet deadlines for delivery to stores but making sure that all the components are in the right place becomes a logistics nightmare. A breakdown at any stage can cause lost production or late shipment. Just-in-time delivery systems reduce inventory cost but increase the risk of production lines being interrupted for any reason. Even a small component not in the right place at the right time can have huge consequences. The following illustrates how interconnections can lead to problems.
More turbulence – just as the world economic environment is no longer benign, neither are industries stable. Cosy national monopolies are no longer protected and companies doing well today can be making losses tomorrow. The shortening of product life cycles and the rise of new industry leaders, only to fall again in some cases, is evidence of this. Think about Apple – it was one of the leading PC manufacturers until it was marginalized by the Wintel PC standard. A few years later Compaq expanded and became the leading seller of PCs only to be supplanted by Dell a few years after that. Who will supplant Dell? In the aircraft manufacturing industry Boeing dominated aircraft sales for decades but has been overtaken by Airbus, a business only started in the eighties. These things are signs of increasing turbulence – stormy conditions. As emerging markets open themselves up and grow on the backs of only one or two main industries, textiles or electronics for example, they become more vulnerable to such turbulence.

Increased volatility – when turbulence hits, the degree of change that occurs, volatility, is much more significant than it once was. Companies and industries can be destroyed almost overnight. In Asia, stock markets have risen hundreds of percentage and then fallen again. The Indonesian rupiah fell from under 2,000 to the US Dollar to over 10,000, stabilized and then fell again.

Airport woes

In 1998 Hong Kong opened its new airport but it suffered severe technical problems in the first few weeks causing problems with checking-in as well as handling baggage.

These problems had severe knock-on effects as cargo and courier companies could not deliver their goods. Companies failed to meet deadlines and lost business or had to make penalty payments. Some went out of business as a result.

Companies in the US did not receive goods destined to hit the retail shelves at critical target dates and lost business as a result.

We can soon see how the consequences can add up quite significantly. A good example of systemic risk. It is not surprising that such problems made those complacent at the time about possible Y2K risks think a bit more seriously.
Accelerating pace of change – in the early part of the last century products hardly changed, even over 30 or 40 years. You bought something and expected to replace it only when it wore out. That is no longer the case. The changes that occurred from 1960 to 1970 in product capabilities were modest as were the changes from 1970 to 1980 but each decade the pace of change has increased. Take television equipment. Television was first made available in the thirties, colour TV came in the sixties, video recorders only really took off in the eighties. Now we have DVD players and recorders, satellite TV, wide screen and interactive digital TVs, video recorders with built in hard drives. Where to next?

Further consolidation – size has become more important as expenditure on R&D costs have increased significantly and for every success there are dozens of failures. Getting bigger means more influence and the ability to rationalize through cost cutting, de-layering, re-engineering or whatever the latest management fad is. Multibillion takeovers/mergers are now the order of the day.

While we can expect this to continue there are limits. Boeing, for one, has swallowed up all its rivals, or they have gone out of business, except Airbus. Regulators are concerned about increased concentrations of economic power and have stopped proposed mega-mergers. The difference today is that the reference point for considering monopoly power is no longer the percentage of sales in national markets controlled, but the percentages of regional or global ones.

Enhanced external scrutiny – various industries have regulators who are becoming more intrusive. National laws are being enacted, protecting workers or consumers rights and various lobbyists are attacking companies for unfair practices, breaches of environmental protection and so on.

Senior management now have to be able to respond to these developments, not by fobbing them off or paying lip service to them, but by being able to show tangible evidence of what they are doing. It is no longer sufficient to say you are going to reduce toxic emissions, you must show how this is to be done and set targets and dates by which they are to be achieved. You must then deliver on your promises.

Corporate and social responsibility is becoming a big issue that is particularly relevant for companies operating in or doing business with emerging markets – Gap suffered a boycott of its products when it was exposed as having used suppliers that employed child labour, for instance. Attitudes are changing and customers are becoming less tolerant which makes it all the more important for managers to anticipate events which
may have an adverse impact on them or their customers. In addition, lob-
byists are seeking to raise standards of corporate governance in emerging
markets. No longer can families ignore the wishes of minority shareholders
with impunity or feather their own nests at their cost.

All of these things will continue to a greater or lesser degree in the
future. To date, these changes have meant that the dividing line between
success and failure has become much finer and, while this has had signif-
icant impact in developed countries, the impacts are increasingly being felt
in emerging markets.

How should we view the future then – with optimism or trepidation?

**Threat or opportunity?**

In Chapter 1 we defined risk as *the uncertainty of future outcome(s)*. The
reason for this broad definition is that reward does not come without
taking risks. Business people focus on upside risk. Daniell takes this a step
further by turning round his net at risk formula into a net opportunity cal-
culation. On the one side is:

> the value of the opportunity *adjusted by* the likelihood of the
  opportunity occurring.

While on the other side we have:

> the ability to capture the opportunity *adjusted by* the likelihood of
  that ability being realized.

In emerging markets there are many opportunities and that is what has
made them attractive to both business and financial investors. The corol-
lary, of course, is the enhanced level of risk that goes with this.

Realizing this potential opportunity requires companies to identify possi-
bilities and take the necessary steps to realize them. While doing so they must
take full account of known risks and protect themselves against the possible
impact of unknown risks. If they can deal effectively with both sides of this
equation they will do well. The problems going forward are:
there are more unknowns than there have ever been before.

And:

the pace of change is faster than it was previously (and getting faster).

The future was looking fairly rosy in Asia in the mid nineties, after years of fast growth and rising standards of living, but that has all changed and instability and uncertainty has undermined investors’ optimism. This change has not only occurred in Asia. Other regions have had problems of their own. Latin America, Russia and Eastern Europe have all suffered to greater or lesser degrees. Parts of Africa have stumbled backwards while others grope forwards slowly. The problem now is finding the opportunities and avoiding unnecessary risks.

The saying goes that every cloud has a silver lining and many companies have seized the opportunities presented by the downturn to invest in emerging markets at less cost than they would otherwise have been able to do. Banks, finance companies and manufacturers have all acquired interests in businesses suffering from the effects of economic turmoil. It has not been easy as strings are often attached, things supposedly agreed and documented are not quite what the purchaser thought, and bringing acquired businesses up to international standards can be problematic. Cultural issues undoubtedly cause problems as does the almost inevitable need to shed staff that is never an easy thing to do in countries where unemployment rates are already high.

Many companies that have not made acquisitions have increased their levels of purchasing activity in emerging markets. With most currencies collapsing, goods became substantially cheaper than they were previously. The resulting increase in orders was a significant factor in the fairly quick rebound that some countries saw after negative GDP growth rates in 1998 and/or 1999.

Where to next? The slowdown in the US economy has already resulted in lower purchases and reduced investment activity that is raising concerns. This is suggestive that the path for emerging markets is going to be a fairly rocky one. The Asian crisis was a shock to a lot of people. In hindsight the root causes were fairly evident but were ignored because many observers were blinded by the Asian economic miracle that had seen near double digit growth rates for a decade or more. The downturn was severe but short lived. Now the fear is that the upturn will be equally short term. Similar swings in fortunes have been seen in Latin America where crises in Mexico, Brazil or Argentina have caused actual or potential problems for
neighbouring countries. In Eastern Europe, Russia is still a significant trading partner for the former Communist bloc countries so its problems have had knock-on effects amongst its neighbours. All of this means that we can expect more volatility in emerging markets in the 21st century than we saw late in the 20th century because of the greater degree of interconnectedness and the inability of governments and international institutions to defend exchange rates in the face of concerted efforts by speculators.

Another important factor going forward is going to be China. China did not suffer the same degree of dislocation as others in Asia because it had:

- less exposure to trade due to the size of its internal market;
- not permitted its currency to be freely exchangeable (reducing opportunities for speculators);
- very large reserves that have enabled it to weather the storm.

Without this bulwark the downturn in Asia could have been much more disastrous.

Today it remains a magnet for foreign investment which will increase with accession to the World Trade Organization. The problem for other emerging markets is that China is attracting a disproportionate amount of the investment pool and Asia is becoming much more China-centric than previously. This is likely to increase as China continues to open up. The reasons are fairly obvious, particularly when we recall the problems investors have had in India with the Dadabhol project. This is not to say that everything is perfect in China but the environment is more attractive and the long term potential that much greater.

This leads on to the final point in this section which is that it is up to the local governments to make their countries attractive to investors through removing obstacles, increasing transparency and keeping their promises. So far their record on this in the early part of the 21st century has not been encouraging. All this suggests that the level of risk is going to continue to increase. With this in prospect how can the management of companies working in or with emerging markets look forward with confidence rather than trepidation?
Risk management’s response

We have already discussed how the risk management profession has evolved in the last 20–30 years in response to new and emerging risks, the faster pace of change and the increased integration of the world’s economies. The result is, in an ever-increasing number of industries, the advent of full time risk professionals. It is inevitable that this trend will continue and that the risk profession will continue to develop both theoretically and practically.

Likely developments in risk management

While the future is unclear it is fairly certain that our understanding of risk and the tools and techniques needed to measure and manage it will continue to evolve not only in those areas where they are currently well developed, but across a broader range of industries and geographies. What is leading edge today in developed economies will become commonplace in emerging markets in due course though clearly the speed of migration will require limiting factors, such as those detailed in the next section to be addressed.

Predictions are:

risk management will become mainstream – attitudes will change and risk management will be embraced by all levels of manager;
tools and techniques will continue to develop and will encompass more of the risk areas that are difficult to quantify today.

To achieve the above will require the:

continued development of risk management enablers.

Let us take each of these three statements in turn.

Risk management becomes mainstream

This is a necessity not a nice to have. Household names are under threat and many have failed because they have been too slow to react to changes in their environment or have entered into new ventures without properly assessing the risks. To make this happen will require:
Greater integration of risk and strategy – businesses will be more vulnerable to failure unless line managers take due account of risk issues and involve risk professionals up front. In turn, they must be allowed to give an independent view on risk that is valued.

Improved risk awareness – this is important but will not be enough without a willingness to act on risk information and discipline to make changes when thresholds are reached or people clearly step out of line.

Clearer roles and responsibilities – risk management will not become part of everyday management until people accept that they are responsible for managing risk. This requires the centre to devolve responsibility and authority to the line and set itself up as a consultant and independent conduit to senior management and not as a controller of risk. They must develop and own the risk framework but leave management to make decisions within that framework only intervening as circumstances change, problems occur or adverse trends are evident. This is a difficult transition for people, both those in the centre and those in the field that were brought up in a command and control environment.

Adequate understanding of risk tools and techniques – this does not mean everyone needs a degree in mathematics or statistics but they should have sufficient knowledge to understand the basics e.g. why it is important to hedge interest and exchange rate risks to protect profitability.

All of the above will depend on having the right people and appropriate reward mechanisms in place that encourage appropriate types of risk behaviour – in other words a strong risk culture. To make that happen requires leadership from the top, involving clear messages and actions that support the words. Companies that do best decide their strategy and stick to it irrespective of short term problems. Understanding what is a short term problem and what is a long term shift in market potential is however not easy. The need for this is even more important in emerging markets where companies need to be there for the long haul.

Tools and techniques

Increasing awareness of risk is a key requirement in developing risk culture, but at a more practical level people need a better understanding of existing risk tools and techniques both for measuring and managing risk. In addition, they will need to keep abreast of developments that are continuing at a rapid rate in the following areas.
Models – technology is allowing the development of more sophisticated risk models which are able to more accurately represent the real world. Risk models are helping us understand risks better and are able to provide more timely and accurate measures of the size and probabilities associated with risks. Models are being used to develop the means for assessing risk on individual transactions, whether it be credit card applications or the ability of cars to withstand the impact of crashes. We will see more and more models being used. They will expand in terms of the types of risk that can be modelled and the geographies they are able to operate in. Model risk remains a potential problem, however.

Scenarios and stress testing – the ability to develop scenarios and extrapolate current exposures through them based on strategic plans has moved forward enormously in the past ten years. Such capabilities will be an important part of forward looking risk management in years to come. Combining these capabilities with new techniques such as neural networks will allow the development of powerful systems that will build scenarios automatically and then test and report on potential outcomes. At present, use of these approaches is limited by human imagination and processing power. Both will change in the future.

Portfolio management and concentration risks – an important rule in risk management is to avoid concentration risk. Putting all your eggs in one basket can be a recipe for disaster if something unexpected goes wrong. To manage concentration risks, however, requires good information on where your risks currently lie. To know this you need good data and the ability to manipulate it in a variety of ways.

Portfolio management requires the ability to aggregate data and to model the impact of any single decision on the overall risk profile of the organization. This is a very different approach to today where risk decisions tend to be taken in isolation. Risks are taken on and they remain until the underlying transaction is completed – credit risk is extinguished when a loan is repaid, operational risk once a production process is complete and so on. What is not usually assessed is how much that extra order from your major customer increases your concentration risk, or whether cutting back on staff in your back office disproportionately increases your operational risk. The ability to assess these and other issues more effectively will develop. In emerging market terms, companies should know whether setting up operations in new territories increases or decreases risk for the organization. At present, the questions are not always asked and even if they are, we have
limited ability to answer them. One way this is being addressed is through setting risk appetite thresholds (see below). New transactions are then modelled to assess their impact on the overall level of risk.

**Leading indicators** – being ahead of the pack will become increasingly important. If you are able to see risks before others and then reduce your exposure either directly, through selling it off, or buying protection then you are likely to be a winner. In emerging markets, creative thinking is needed to develop appropriate leading indicators but ruthless application is required once the warning signs are evident.

**New risk management techniques** – much of the above relates to enhanced means of identifying or measuring risks, but what is important for businesses is the ability to be able to manage risks once identified. As in other business areas there is continual innovation, and new techniques are being developed and tested. Some work while others do not. Those that work become mainstream and the innovators move on to develop something new.

Such developments often arise through innovation in existing business areas but in other cases they break new horizons. The development of foreign exchange forwards was a development of spot trading that subsequently led to the development of the forward exchange option market. Similar developments occurred in interest rate markets so that there is now a wide range of complex products on offer including floors, caps, collars and many exotically named products. Trading energy futures and weather risk cover are newer developments in completely new areas of risk management. Alternate Risk Transfer (ART) techniques is another area much talked about at present. ART techniques include securitization of low probability but high impact risks, catastrophe risk for instance. See Gerry Dickinson’s article in *Mastering Risk* (2000) for a detailed explanation.

These techniques are increasingly complex and will continue to develop in ways we cannot currently think of. To date, they have been largely restricted to the finance and energy sectors but in ten years we can imagine that all sorts of risks will be tradable, including many risks from operating in emerging markets. To do this, however, requires heavy duty computing power and volumes of good quality data that will remain a challenge in emerging markets.
**Enablers**

*New theories* – we cannot imagine what theoretical developments there might be around the corner. Risk managers are comfortable today talking about Expected Loss and Value at Risk even though they had not heard the terms a few years ago. Looking forward we can expect further developments in those areas where a fairly numerate approach can be adopted but more importantly this will be extended to areas currently difficult to measure. The prime candidate is operational risk but reputational risk is also gaining a lot of attention. Real options, the extension of financial option theory to the non-financial arena, is another area where there is an increasing literature – see Jeffrey Reuer and Michael Leiblein’s article in *Mastering Risk* for an introduction to this area which has considerable application in emerging markets.

*Technology* – risk management has moved forward in leaps and bounds in the past ten years as a result of technology developments. This is not all good news as technology increases risk, but without it many risk management developments would not have been possible. Technology has:

- lowered communications costs;
- increased accessibility – fax, e-mail, intranets;
- allowed automated systems to monitor risks, and take appropriate action if thresholds are breached, 24 hours a day;
- supported the development of automated credit decision engines;
- helped create self learning systems such as neural networks which adapt decision making rules to changing circumstances.

Just the development of the internet has had a profound impact on how businesses are run and managed. It is a very effective means of sharing information and keeping that information up to date at low cost, but it has proved expensive to develop and few have been able to cover their costs. After the initial euphoria there is now a more sober approach being adopted. Mature companies see it largely as an alternate delivery channel or as a means to improve communications internally while many start-ups are falling by the wayside. The result has been a shift of resources away from developing customer facing internet applications to inward facing intranets. This approach allows enhanced information sharing and the dissemination of strategy, policy and other communications much more cost effectively.
than before. We can expect more devolution of power but somewhat paradoxically the centre will know more about what is going on across the globe. As system capabilities develop, this will increasingly be available in real time. This will help spread good risk management practices.

**Public data availability** – more and more information about virtually everything is becoming available as public records go on line or as fee charging data agencies, such as credit bureaux extend coverage globally. Credit bureaux continue to expand and capabilities are becoming more and more sophisticated. To date, coverage and sophistication in emerging markets has been limited even in the most advanced ones. Part of the reason is cultural barriers, such as the fear of giving out private information, but this will change, albeit perhaps more slowly than people would wish. Pressures for more transparency will help migration while increasing competition in developed markets will spur newer and more sophisticated techniques. Such techniques are, however, likely to become more expensive and require more and more data to run them effectively. This is likely to lead to continuing consolidation in the industry.

**Expert help** – one of the features of the changing face of risk is increased specialization, whether it be in model expertise, reputational risk, personal security or environmental damage limitation. Each of these, and many other areas, has spawned an increasing range of experts and an explosion in the number of consultants looking for a share of risk management budgets.

**Information for sale** – in addition to consultancy providers there are many purveyors of risk management information – country risk reports and ratings being an obvious one of relevance for those operating in emerging markets. With the internet having broken down barriers to entry, the range of on-line services is likely to increase – provided people are prepared to pay for them. Given the increased levels of risk in emerging markets there should be an expanding market for those who are able to provide value added services.

**Education and training** – risk management is becoming ever more technical and people must continually learn and develop to maintain and expand their level of knowledge and expertise. Losses are made but they are wasted investments if lessons are not learned from errors or unexpected events. Real events turned into case studies can be powerful tools for changing opinions and proving that risk is real rather than theoretical. Going forward, new ways must be found to keep people up to date and they must be encouraged (required?) to do so.
Professional qualifications in risk management, rather than simply parts of other courses, are more and more common and it is likely that the pace of growth will be greater than traditional subjects such as financial analysis.

All of the above suggests that risk management will continue to develop and this will help those companies who are able to learn from past lessons and anticipate risks. There are, however, obstacles to overcome.

**Limitations**

Risk management is not a panacea nor is it something that can be managed from the centre. For a large operation risk management expertise tends to be centralized at Head Office and people in New York, San Francisco, London or Geneva are not going to be able to manage day-to-day risks in Bogota, Gaborone or Beijing. They can design the risk management framework and set policies and procedures but they do not know the areas in which business is being conducted as well as local management. They can oversee risks and compliance but only as far as they are allowed to and only within their own frame of reference and level of understanding. Delegation is a must in an increasingly complex and turbulent world but this must not be seen as abrogation of responsibility. Areas that must be addressed are:

*Risk management responsibilities do not lie with risk professionals* – to reiterate a point made earlier, front line management has to accept that they have responsibility for managing risk and not “those risk people in Head Office”. They must accept that managing risk will actually help them achieve their goals and not be a hindrance. Where this is the case, we can suggest that there is a strong risk culture, but few companies have achieved this even in areas such as finance and banking where risk management practices are much more developed. If risks increase faster than our capabilities to respond to matters, as Daniell has suggested, are going to get worse rather than better. Those that do succeed will reap the rewards while others disappear from the playing field.

*Tools and techniques for managing risk must be treated with caution* – models are what they are, a representation of the real world. All models rely on assumptions which, when back tested, may fit well with past data sets but this is no guarantee that they can accurately predict the future. Undue reliance on “black boxes” is an increasing risk. Where used wisely, models and automated systems can improve risk management through streamlining processes and ensuring consistent decision making. The ability to use
models in emerging markets remains problematic but even where they are of some use, fundamentals can change quickly and undermine their applicability. Judgement will continue to be of importance not only for this reason but because the range and nature of risks in these environments is such that models could not possibly capture them all effectively. How do you model the probability of a coup, a tornado striking or irrational legislation? How do you model interconnected risks or risks that, so far, are unknown or are unforeseeable? The answer is clearly, with difficulty or not at all. Technology will not solve all these problems and is likely to create others.

Cultural divides – we have highlighted the need to understand the culture and values of the countries in which you are doing business and how these differ from your own. Understanding, tolerance and patience are the keys. Shouting louder until what you want done is done is no longer an option. This might get the job done but it will lead to resentment and the probability that you will get paid back somehow at a later date.

Data demands will increase – more and better quality data will be required to manage risks but the ability of emerging markets to meet this requirement is limited. Improvements are happening but not fast enough. Public data remains limited and even company internal data is not as good as it could be. Unfortunately, automation can help but it is not a sufficient solution as the rule of “rubbish in rubbish out” remains. Data entry quality remains problematic without adequate checks or incentives to get it right first time round. Even where there is data available, data protection laws are curtailing the ability of companies to share or buy it. At present this is less of an issue in most emerging markets, but it is likely to increase. In some cases this can mean that even providing Head Office with information can be a problem.

Measuring success – unfortunately risk management is one of those activities where people only remember when it does not work. We remember the loss events not the risk decisions that were correctly called. Y2K is a good example of where people have argued that level of risk was overplayed and too much money was spent on risk mitigation. No major breakdowns were publicized but some undoubtedly occurred as did many smaller ones. If no action had been taken, problems would clearly have been greater than they were, as pre-Millennium testing found large numbers of problems. Who can say who is right? If you decline a loan and the company goes from strength to strength, people will say you were too cau-
tious. If it collapses, will anyone remember that you said no? We have argued that it is important to involve risk in strategy setting but have warned that we all have a different view of risk. Risk professionals need to earn respect to have their voice heard but earning that respect is not easy.

Clearly there is much to be done to push risk management into the forefront of line manager’s consciousness. Understanding and effectively managing risk requires people to behave in an appropriate manner. People are at the centre of risk and risk management.

People issues

People have created the more complex world that we live in today, which has led to increased levels of risk and uncertainty. In emerging markets ruthless despots, unpredictable governments or restless populations have create further problems and increased the probability of sudden and violent change. People create pollution and global warming, they have spread AIDS, they invented cars and aeroplanes, and the consumer society. Populations are increasing, people are more educated and more demanding, the level of inequality is increasing – in emerging markets as well as in developed ones – and these trends are likely to continue.

These points suggest that people issues are behind many of the risks that we see today. Recent events suggest that risk and volatility is increasing and this has been caused by people – unrest from those that have suffered in the economic downturn or promises made by politicians but not delivered on. Going forward these issues are unlikely to change for the better. The more global the problems, the harder it is to come to an acceptable solution. Even where problems are contained within national boundaries, finding solutions can be difficult because there are always winners and losers, and in emerging markets losers can be more vociferous, unpredictable or violent.

The key to managing risk more effectively is going to have to involve people. We have mentioned some of the issues – line management taking responsibility for managing risk, making sure the right people are in the right jobs, rewarding people for taking the right risk decisions (including saying no sometimes) and addressing cultural issues. Flexible management must replace command and control. Authority must be delegated and then managed with a soft touch. Respect and trust will follow.

A problem with this is that often people are afraid to take risks. The reason for this is they either fear failure, or more likely the consequences of failure, or that past behaviours of management has not been conducive
to risk taking. This will always be a problem in some cultures, especially hierarchical ones which have high respect for seniors.

Going forward one of the key tasks for managers will be to encourage risk taking and be supportive when failure occurs. Pushing boundaries should be encouraged but in a controllable manner and with due consideration of risk. People need to be made to realize that failures come before successes. New recruits are permitted failures, because they do not know better, so why not existing staff when they try something new? This does not, however, mean that anarchy should be permitted or no punishment given where there are clear breaches of rules or reckless behaviours are evident. Similarly, doing something that has previously failed requires a response. The dividing line will be hard to define but staff must feel safe taking risks. An increasing tolerance of risk taking will be one of the differentiators between winners and losers going forward.

A potential problem with people will always be staff turnover. This can be particularly acute in emerging markets as the pool of talent is limited and demand is increasing. Until the imbalance is addressed, keeping good staff will always be difficult. This is particularly so for foreign companies who seek people with language skills and an understanding of Western cultures. Such companies can usually offer attractive packages, including overseas assignments, but, if local operations are modest in size, opportunities to move up the corporate ladder will be limited and it is almost inevitable that ambitious people will move on. An unfortunate consequence is that some people get promoted too quickly and are unable to cope with the demands placed on them. Increased benefits, almost paradoxically, seems to promote higher and higher expectations of future rewards. They certainly do not buy staff loyalty, that is an increasingly precious commodity in today’s world.

Risk/reward

It is all very well considering how risk management tools, techniques and practices will develop, but doing so in isolation is somewhat of a futile exercise. We argued in Chapter 4 that managing risk starts with setting strategy but this premise is not fully accepted in major companies or, if it is, they do not always practise what they preach. This can be tested by seeking answers to the following questions:
- is there a board member responsible for risk?
- are risk professionals fully involved in determining strategy?
- have the board clearly defined what their level of risk appetite is?

The first two questions are fairly self evident but the last one requires a little explanation.

**Risk appetite**

By risk appetite we mean the willingness of the board to accept losses. To assess this we need to consider a company’s profitability and its balance sheet position.

Company budgets will define the target level of profits for the next financial year and may look forward, with less confidence, for the next three to five years. These budgets are based on various assumptions regarding the environment, customer and competitor behaviour, values for key variables such as interest and exchange rates, etc. At the start of the financial year, the company will have a projected profit and loss account and an opening balance sheet position. If things go wrong the company will cover losses from one part of its business from profits earned in other parts or those made earlier in the year. If these are not sufficient a net loss will be reported and the value of the capital and reserves account will be depleted. If there is inadequate capital, the company may well fail.

Given that management is paid to deliver long term growth in shareholder value they need to be confident that their plans will deliver expected profits and that those profits will enhance the company’s share price. Increasing risks and greater volatility have meant that boards are now being asked to set down more clearly what their level of risk appetite is, e.g. for line of business x what is the maximum level of loss that is acceptable? The board must be part of the risk assessment process. They cannot sit above it and blame those below them or “unexpected events” if things go wrong. They must consider the downside alongside the upside and place limits on risk taking. Let’s take an example.
A company is planning an acquisition in a country it has not operated in before. The cost of the acquisition is USD 100 million and it is expected to generate profits of USD 10 million in Year 1, USD 15 million in Year 2 and USD 25 million in Year 3 based on best-case assumptions. Should the board say yes or no?

Clearly without further information it is difficult to say. Let us assume that an alternate scenario is losses of USD 10 million in Year 1 rising to profits of USD 20 million in Year 3. This does not take us much further ahead unless we understand the overall position of the company. If current projections, excluding the above, are group profits of USD 50 million in Year 1, USD 60 million in Year 2 and USD 75 million in Year 3 and current paid up capital is USD 250 million what answer should we give?

On the original scenario, profits in Year 1 go up 20 per cent but in the second scenario they go down by 20 per cent. That might be acceptable if this was the worst case and long term the acquisition was expected to do well. What if it went badly wrong and the company had to write off the investment?

In this case the USD 100 million cost would have to be offset against profits, wiping them out completely, and then against the company’s capital base.

The company would survive but might be severely damaged and either limp along before later collapsing, or face being taken over. If its capital base was only USD 75 million it would be insolvent and most likely collapse.

In this example management face the decision as to whether to take the risk of making the new acquisition or not. The larger the company’s other profit streams are, and the larger its capital base, the less impact the acquisition going wrong would have. It would seem from this that increasing your capital base is an adequate risk mitigant but, unfortunately, having more capital increases costs.

Setting risk appetite is about defining the point at which board members become uncomfortable. To put it another way it sets boundaries on how willing they are to bet the future of the company on events turning out as they expect. Another term for this is concentration risk. It is a fine balancing act but one that has not been well done in the past.

In emerging markets the risks are higher and the need to manage concentration risks are more important. Things can go horribly wrong as UK based supermarket chain Sainsbury’s found out in Egypt. They recently
announced they were pulling out of the country after only a few years at a cost of over USD 150 million because expectations had not been met. This was a blow to them and put a dent in the current year’s profits but did not lead to anything worse, as this was small in relation to the overall size of the company. For a company with a capital base of only USD 100 million it would probably have been the end.

Going forward it is important that company boards set risk appetite parameters clearly and that these are monitored regularly. As risks and strategies change or the financial strength of the company improves or deteriorates they need to be reviewed and updated as appropriate. The catch, of course, is that to set risk appetite parameters you need to have adequate measures of risk which takes us back full circle to the expected developments in risk management detailed above and associated limitations.

On a more positive side there is a need to appreciate that the flip side of risk is opportunity. Risk managers are often accused of stopping business through concentrating on the downside aspects of a situation and line managers of being reckless through failing to consider risk. This is much the same as labelling those who see a bottle half full as optimists and those who see the same bottle as half empty as pessimists. If we all see the same thing and think positively, a better result will be achieved.

**Risk and opportunity**

A recurring theme of this book is that risk management is not about saying no, but helping people say yes. It is about helping people make more informed judgements when faced with risk and uncertainty. This is important because in today’s fast changing world those companies that cannot adapt will not survive. To survive, companies need to take risks. Companies that believe they can live off what they are good at doing today will struggle in the future. This is true even if they are good at what they do and have been good at it for a long time.

If Encyclopaedia Britannica had understood it was in the business of communicating knowledge rather than being a producer of encyclopedias it might have made a bolder decision and taken a risk when approached by Microsoft. The ice company that turned away the opportunity to develop refrigerators is a similar well known case. There are many more we could recount.
Dealing with emerging markets involves taking on new risks which has strong parallels with the Encyclopaedia Britannica case study. They each involve a step into the unknown which people are naturally cautious of because it moves them outside their comfort zone. A better understanding of risk in emerging markets combined with the development of new and better tools and techniques for managing risk can help enhance that comfort zone. To do this requires a good understanding of the risks in those markets and tools and techniques appropriate to the particular risks and uncertainties that exist therein. This will involve adapting proven best practices as well as developing new ones. In doing so, new opportunities should be revealed. The following illustrates how new opportunities in the banking world have developed from new risk management tools developed for managing risk.

Encyclopaedia Britannica has been the foremost producer of multi-volume hard bound encyclopaedias for many decades. These were popular with libraries and families who wanted a rich source of information for their growing children, but they were expensive. Many people purchased them in instalments over lengthy periods and then cherished them for a lifetime. This was all well and good when things changed little from year to year.

In recent decades the pace of change has increased and the boundaries of our knowledge have expanded rapidly. Consequently bound copies are likely to be out of date as soon as they are printed.

In the early nineties Microsoft was looking to develop a product containing encyclopaedia type information in CD-ROM format. They approached Encyclopaedia Britannica to provide the content but they were turned down. Microsoft decided to develop their own version and the very successful Encarta series was launched. This has gained the lion’s share of the new interactive market. Much cheaper, and capable of upgrade on-line, this product is more in line with consumer needs.

Belatedly, Encyclopaedia Britannica has joined the on-line market but its market share is modest at a time when demand for bulky bound copy products is declining.

Missed opportunity
The development of business opportunities through techniques such as behavioural scoring requires risk professionals and line management to work together. The ideal is for risk managers to understand business needs and line management to understand risk management. Neither will be experts in each others’ fields but they should have enough common ground so that:

**Behavioural scoring**

Until recently, banking was viewed as a rather stuffy and unadventurous profession. Everything revolved around branches and bank managers who were senior and experienced people. There was little competition and business development involved waiting for customers to ask for a loan. Decisions were made by the branch manager, or in Head Office, after a slow and tortuous process.

Today everything has changed and competition is fierce for custom, branches have been transformed into sales outlets, and branch managers no longer have an aura about them.

One way that has been devised to support business development is behavioural scoring. In short, this is a technique for mining vast volumes of data and identifying not only potential target customers but ranking them in terms of any one of a number of defined characteristics.

To do this it is necessary to use modelling techniques to determine which characteristics are associated within desired behaviours e.g. will people who are about to make the final instalment on a loan be more willing to take up a new one than people targeted at random? If the answer is yes, then a mailshot to such customers will be more cost effective than a general one.

You can see the evidence of this approach in your mailbox almost every day. Junk mail is now more likely to be for things that coincide with your interests and possible needs, than five to ten years ago.

Behavioural scoring can be used for a variety of purposes including identifying people more likely to default on loans, determining the most appropriate techniques for contacting people once they have defaulted, as well as targeting new business opportunities.
• risk managers can identify business opportunities or suggests ways in which risk can be mitigated and still produce an attractive customer offering;
• line management builds risk assessment into its business processes from the start and knows when to call in the risk experts.

If this can be achieved, then the risk culture within your organization will be strengthened and the chances of success increased. This will be all the more important where you are operating in emerging markets, particularly if your risk managers are in Head Office and your line managers are in the field. Seeing risk managers more as consultants than adversaries will mark a significant shift in opinion and help cement a more productive future for businesses.

**Conclusion**

Risk in emerging markets is higher than in developed ones. Expectations are that the level of risk will continue to increase, as will volatility. This, however, is not a reason for retreating to one’s comfort zone, as risk creates opportunity and seizing opportunities is the way in which companies develop and grow.

The rewards from doing business in and with emerging markets can be sufficient to cover the increased level of risk but they can only be achieved through proper risk assessment up front and continual reassessment, because we cannot know the future. All we know is that it will be different and that we will probably have to manage risks in ten years’ time that we cannot currently conceive. This is exciting as well as challenging, and requires everyone to understand and manage risk much better than they generally do now.

From humble beginnings, risk and risk management have grown into a veritable industry. In the future companies will succeed not through bigger and bigger risk management departments but through line managers understanding and managing risk effectively. Tools and techniques will continue to develop and technology will help this process, but the key will be people, as only they can use judgement and respond well to the unexpected which occurs all too often in emerging markets.

*Hope for the best but plan for the worst* must be the watchword when dealing with emerging markets.
The world is not static but changing rapidly and at a seemingly ever-increasing pace.

Increased interconnectedness means that we face new risks almost everyday, not least in emerging markets.

To respond to increased levels of risk, risk management disciplines have spread across many industries and there are now many more risk professionals.

Despite the growth in the number of risk professionals, responsibility for managing risk lies firmly with line management, risk professionals provide support.

The types of risks that businesses face are more pervasive and require cross-border co-operation to solve. The ability of governments to deliver is, however, limited and not improving.

There are many drivers of change, some are creating new opportunities in emerging markets particularly in technology.

Looking forward we can expect that current trends such as globalization, increased complexity, greater volatility, and so on will continue but there will undoubtedly be some unexpected events.

To help managers of risk, tools and techniques will continue to develop and will encompass more of the risk areas that are difficult to quantify today.

References


In particular see:


The text of this book was written prior to the tragic events of 11 September 2001. In the immediate aftermath the perception was “the world has changed forever”. Now, some months later, this phrase is less often heard and a sense of normality, as far as that is possible, is returning.

What about emerging markets? We have stressed throughout this book that emerging markets present attractive opportunities for companies who are able to understand the many risks that their businesses face and manage them effectively. This proposition remains unchanged. The risks in emerging markets are also unchanged but what has changed is the degree of uncertainty and the particular types of risk which need greater focus such as physical security and price movements in currency markets. In due course, credit risks will rise as may country risk. How will emerging markets fare in the immediate future and how should companies react?

The immediate concern is clearly the depth and length of the downturn in the US economy as this will reduce the volume of imports much of which come from emerging market countries. This is not a new issue though. Textiles and electronics imports were already declining prior to 11 September which had had an impact on countries such as Malaysia, Taiwan and Singapore in Q2 2001. Negative growth rates are already being seen, or are expected, in Q3 and Q4 of 2001 as a result for many Asian countries. How long this lasts will be determined by how quickly US consumer spending trends upwards again. Current expectations are that this should not be expected until the latter part of 2002.

In other parts of the world the US downturn will be felt more fully through falling purchases of mineral and agricultural products. This fall in demand is likely to lead to falling commodity prices producing a double
blow for emerging markets heavily dependent on primary exports. Oil is a good example. Oil prices rose sharply in mid September but then drifted down to their lowest levels for some time as realization set in that orders were going to start dropping as the recession in the USA kicked in. In addition, some countries have already seen tourism receipts drop as overseas conventions have been cancelled and people have decided against traveling away from home.

This all sounds like bad news for emerging markets but we should not forget that in all situations there are winners and losers. Lower oil prices will reduce foreign currency receipts for oil exporting countries but most emerging market countries are importers and they will benefit from reduced import costs. Similarly, there have been substantial reductions in US interest rates which other countries have followed. Lower rates will reduce debt burdens for governments and help corporate borrowers who are highly leveraged.

The other point to stress is that many emerging market economies, particularly in Asia, are in a stronger financial position than they were in the mid to late 1990s. Many have managed to build up foreign exchange reserves and have undertaken structural and other reforms that will be beneficial through the coming downturn. What is likely however is that GDP growth rates will fall or become negative, companies will default and close or, as we are already seeing, start laying off workers in a desperate attempt to stay afloat. This will increase social and other tensions and have adverse impacts on the banking sector that, in many countries, is still struggling to come to grips with credit losses from the last downturn. The concerns raised previously about those governments who failed to see through reforms are likely to materialize. We would expect therefore to see better results from those countries that saw through structural reforms than those that started but did not finish.

The impact will clearly vary considerably from country to country. Pakistan economically has become stronger as a result of the lifting of sanctions but politically it is less stable and unrest is a potential problem. China on the other hand was little scathed by the Asian crisis and is likely to see a limited impact from the current downturn. Singapore is already suffering its worst recession for more than 20 years due largely to concentration risk – upwards of 50 per cent of its exports are in electronics and most of this goes to the USA. In contrast, little has probably changed in many African countries except for a downturn in primary export receipts and lower tourism revenues in some countries. Russia is starting to show improvement and its prospects have not been better for some time.
Where does this leave managers dealing with risk in emerging markets? In terms of fundamentals the issues raised and tools and techniques for managing them dealt with in this book remain valid. What has changed is the level of uncertainty and in particular the greater likelihood that unexpected events may occur. For some, security issues will be of concern; for others it will be the downturn in local and export orders. For the lucky few, exports orders may go up. For those companies already operating in emerging markets or seeking to invest there opportunities will undoubtedly arise. Remember, many a company that got into trouble in the Asian crisis or as Eastern Europe opened up was taken over or rescued by foreign investors who were able to do so at low prices. Such opportunities are likely to happen again. Those who are able to seize those opportunities will be well positioned when the upturn comes, as it undoubtedly will, in one or two years’ time.

In summary, recent events have increased the need for management to understand risk in emerging markets and manage it effectively. New opportunities are or will become available in these markets as events unfold and those that are bold, but not reckless, will be able to reap the benefits in due course.
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