WHITE PAPER

Dealing with Country Risk

Doing business in international markets, especially emerging markets, always involves a degree of risk. The hazards can range from high-level threats, such as a government making unfavourable changes to a country's foreign investment rules, to more mundane ones such as a customer cancelling a contract or not paying an invoice on time.

Trade analysts often refer to these hazards collectively as *country risk*—the overall risk, in a particular country, of any event or dynamic that could keep you from getting paid or prevent you from completing a contract. In this paper, we'll examine what makes up country risk, how you can assess it and what you can do to manage it.

TABLE OF CONTENTS

The Basics of Country Risk 3

Assessing Country Risk 4

- Resources for assessing risk 4
- Country visits 5

Assessing Your Top Risks 6

Managing Your Risks 7

- Economic and financial risks 7
  - *Non-payment risk* 7
  - *Contract risk* 7
  - *FX risk* 8
  - *Bonding and guarantee risk* 9
- Political Risks 9
  - *Changes in local laws and regulations* 9
  - *Import restrictions* 10
  - *Restrictions on moving money to Canada* 10
  - *Breach of contract by a government* 10
  - *Expropriation* 11
  - *Political violence* 11
  - *Using insurance in political risk management* 11

Summing It Up 13

THE BASICS OF COUNTRY RISK

People who work regularly with country risk often divide it into two broad categories: *economic/financial risks* and *political risks*. The former includes threats such as:

- non-payment or late payment risks
- contract risks
- foreign exchange (FX) risks
- bonding/guarantee risks

Others could be added, but these are among the most common economic risks for Canadian small and medium-sized enterprises (SMEs)[1] that engage in international trade.

Political risks, which can dramatically influence a SME's operations in an overseas market, include:

- changes to local laws and regulations that make it harder to operate in the market;
- restrictions on imports into the country;
- restrictions on moving money from the country back to Canada (also called currency transfer and conversion risk);
- breach of contract by a government;
- government seizure of a company's equipment or inventory, or preventing these assets from being returned to Canada (also called expropriation risk); and
- political violence.

The boundaries between these two risk categories are becoming less distinct, given that government policies and economic activities in many countries have become increasingly entwined during the past decade. Your company may get paid late, for example, not because a customer doesn't have the cash, but because a new government regulation has made it harder to move your money out of the country. Canadian banks, fortunately, are increasingly aware of how political and economic hazards interact and have developed products that can protect you against a wide variety of interconnected risks.

Understanding obligor risk

Country risk experts also distinguish between country risk and *obligor risk*. Country risk arises because of the overall economic and financial conditions within a country, or because of the actions of its government. In contrast, an obligor risk is a hazard that arises solely from the actions of the customer (the obligor) and does not stem from country risk.

[1] Industry Canada defines SMEs as companies with under $50 million in annual revenues, and with up to 99 employees (small enterprises) or 100 to 499 employees (medium-sized enterprises).

The most obvious example of this distinction is probably the issue of non-payment. If you might not get paid simply because your customer is bad at managing money, you are dealing with obligor risk. But if you might not get paid because a country-wide recession is pushing your customer into bankruptcy, you are dealing with country risk.

For a SME dealing with risk at the operational level, however, this distinction may be of little practical consequence. With non-payment, for instance, the best way to manage the risk (whether it's obligor or country risk) is to assess it carefully and, if it's serious, to mitigate it via some form of insurance. Similar strategies could be used to mitigate contract risk, FX risk, bonding risk and so on. In short, both obligor and country risk can often be dealt with in the same way, at the operational level at least.

As Canadian firms continue to look for new business abroad, the need for managing country risk will steadily increase. In stable markets such as the United States and much of Europe, country risk is relatively low and is composed mostly of economic elements rather than political ones. In emerging markets, in contrast, country risk tends to be higher and is made up of a mix of political and economic hazards that varies from economy to economy.

Even in relatively safe markets, however, a prudent Canadian company will keep an eye on its country risk, just as a matter of good business practice. And if you're proposing to operate in emerging markets, where economic and political hazards can be considerably more severe than they are in mature economies, then assessing, monitoring and managing country risk is even more important.

ASSESSING COUNTRY RISK

If you're considering entry into a new market, your market research should include a country risk assessment as part of your routine due diligence. Companies that are good at managing risk usually integrate some level of risk assessment into their business operations and update the assessment regularly. Evaluating country risk should be no exception.

Most SMEs, obviously, can't afford the luxury of a full-scale risk management department. Even smaller companies, however, can formally assign someone from senior management to set up a process that will identify the top risks and find ways to deal with them. This person may be backed up by other company personnel, depending on the workload, and he or she should have the authority to bring in third-party risk experts when necessary. Once you've established how country risk management will work within your company, you should make it part of your routine business activities.

Resources for assessing risk

There is a great deal of publicly available information that will help you assess the country risk of a particular market. Some of the major resources are as follows:

- Export Development Canada (**EDC**) provides a wealth of **economic analysis and**

research that you can use to examine more than 170 overseas markets. The **Country Risk Quarterly**, for example, provides risk information on more than 100 countries, including ratings for both economic/financial and political risks. If you need to know more about a market you want to enter, or about a country where you're already doing business, be sure to **contact EDC**.

- The World Bank Group's **Doing Business** website examines business regulations for local firms in 189 economies and in selected cities worldwide. The **rankings** section looks at the ease of doing business in these places, ranging from starting a company to enforcing contracts.
- Also supported by the World Bank, the **Worldwide Governance Indicators** site provides information on 215 economies in the areas of accountability, political stability, government effectiveness, regulatory quality, the rule of law and corruption.
- The **Country Commercial Guide**s available from the **U.S. Commercial Service** offer up-to-date, detailed information about a huge range of world markets. They're available through the service's **market research portal**.
- The **Global Competitiveness Report** ranks the competitiveness of 144 countries using 12 criteria that include institutional strength, infrastructure, education, training, technological readiness and innovation. Many of these indicators, such as the infrastructure and financial market development rankings, can be very useful for exporters and investors.
- **Transparency International** publishes a yearly **Corruption Perceptions Index** that measures the perceived levels of public sector corruption in 175 countries.
- Other public sources include industry associations; **chambers of commerce**; insurance brokers such as **Willis**, **Aon** and **Marsh Canada**; ***The Economist*** magazine; and various organizations such as the **International Crisis Group**, **Global Risks Insight** and the **Council on Foreign Relations**.

Country visits

One of the best ways to assess a market is to visit it and talk to people who are familiar with its business culture and its risks and opportunities. Before you go, check the list of EDC's **international representation** to see if EDC has on-the-ground representatives in the market. These experts can help you find your way around, introduce you to decision makers and help you understand what risks you may face when doing business there.

Before your visit, you should also contact the **Canadian Trade Commissioner Service**, which has Trade Commissioners in more than **160 offices worldwide**. Assuming you're already well prepared to do business in the market, these Trade Commissioners can help you with information about local market prospects and companies, and provide briefings on current market conditions and their associated risks.

ASSESSING YOUR TOP RISKS

Many of the resources listed above can help you identify the country risks most likely to affect you in a particular market. Once you've pinpointed them, you can go on to assess the probability of each risk and its potential for causing damage. Many risk specialists use a scenario-building approach to do this; if political risk is a particular concern, for example, you might consider possibilities such as these:

- The government's leadership changes in ways that make it less business-friendly.
- The government changes the rules for foreign investors in adverse ways.
- The national economy goes into a recession, which leads to worsening budget deficits and lower government spending.

For a much more detailed treatment of political risk and how to deal with it, you can download EDC's **white paper** on the subject.

If economic/financial risk is a hazard, you might consider scenarios such as the following:

- The government reduces its subsidies for the industry in which your customer operates. The customer consequently becomes insolvent and can't pay you.
- A customer, under pressure from regulatory changes, alleges that you haven't met the terms of your sales agreement and cancels the contract.
- You have a long-term contract with payment in the local currency, and the foreign exchange rate changes so that the contract is worth less in Canadian dollars than you expected.

Your most serious risks, naturally, will depend on your company's size, industry, international markets and financial strength. Their severity may also change over time according to whether they are one-off risks, or cyclical or structural ones.

An example of a one-off risk would be the danger of non-payment for a particular sale. Such risks are relatively easy to identify and understand, and you'll usually know how long they'll remain a threat.

Cyclical risks, by definition, recur within a known time frame. You can usually predict when they'll be a major concern, when they'll diminish and what you'll need to do to deal with them.

Potentially the worst risks are systemic risks—that is, the likelihood of unanticipated events occurring because of the way an economic system is structured or operates. You're most exposed to these risks if:

- You set up or operate an affiliate in an overseas market.
- You hold substantial amounts of cash in an overseas market.
- You hold equipment or inventory in an overseas market.

The presence of systemic risk raises the question of how predictable your intended (or existing) market is likely to be—will its conditions be the same in a year as they are now? In places with lower country risk, the odds are likely good that they will, although surprises can and do occur. But if you really can't say for sure what a market will look like in the longer term, or even the middle term, you should be ready to take extra precautions—or, in the worst case, decline to enter the market at all.

MANAGING YOUR RISKS

Having examined how to identify and assess the risks most likely to affect your international business, we can now turn to dealing with them.

Risk management in general has two basic elements. First, you *reduce the probability* of the risk event occurring in the first place. Second, you take measures to *reduce its effects* if it does become a reality. In this section, we'll look at the most common economic and political risks and outline how you can manage both their probability and their effects.

Economic and financial risks

The economic and financial hazards that tend to be top of mind for Canadian SMEs are non-payment risk, contract risk, FX risk and bonding/guarantee risk.

Non-payment risk

Having an effective credit management system is your single most important tool for reducing the probability of non-payment due to obligor risk. You can find detailed information about how to do this in EDC's guide, **Credit Management Processes that Pay Off**.

But while good credit management will help protect you from obligor risk, it is relatively ineffective against the kinds of country risk that can also lead to non-payment, such as economic recessions or political violence. Careful research and due diligence at the country level are your best strategies for managing risks such as these.

If you do identify a non-payment hazard, whether because of obligor risk or country risk, one very effective way to reduce its impact is to use credit insurance. EDC offers a suite of these **insurance products**, which will typically cover up to 90 per cent of your losses if a customer defaults. **Trade Protect**, for example, can be ideal if you have a small number of international customers you'd like to insure against non-payment. You can apply for a policy quickly and easily online, and there's very little paperwork.

Contract risk

Contract risk is any risk that may prevent you from completing a contract. It can happen for a variety of reasons, including:

- Your customer becomes insolvent (this can be a result of either obligor risk or country risk).

- Your customer cancels your contract without legitimate cause (this also can be a result of either obligor risk or country risk).
- Contract payments are delayed or blocked by government actions.
- The authorities cancel your import permits, preventing you from delivering to your customer and thus keeping you from completing the contract.

If your analysis suggests that contract risk is a hazard for a particular sale, you can protect yourself with EDC's **Contract Frustration Insurance.** It will insure your contract for up to 90 per cent of eligible losses from any of the risks listed above, and from various other hazards as well.

FX risk

Changes in the FX rate of the Canadian dollar can seriously erode your profit margins and cash flow. In the longer term, moreover, FX unpredictability can make your financial forecasts less reliable, which is never a good thing when you need financing from your bank.

Setting up an effective FX risk management program isn't a trivial task, but it's well within the reach of any company willing to make the effort. These are the basic steps:

- Identify the FX risks affecting your company and determine when in your business cycle your exposure arises.
- For each foreign currency in which you do business, measure your level of exposure to FX risk. This allows you to calculate how much protection you need.
- Develop a hedging strategy to provide this protection.

"Hedges" are financial instruments that lock in the FX rate of an export contract, so you know exactly how much you'll receive at payment time regardless of how the rate might change. To use hedges, you'll need to obtain an FX facility from your bank. An FX facility resembles an operating line of credit and can support various types of hedges.

Using an FX facility, however, may present you with secondary financial hazards. This is because your bank will require security for the facility in case you default on repayment. Usually, it will carve this security (which can be as much as 15 per cent of the facility) out of your operating line. Depending on your finances, this loss of working capital could create a variety of risks, such as being unable to pay a supplier or simply making it hard to carry on your day-to-day operations.

If this might be a problem, you can protect yourself with EDC's **Foreign Exchange Facility Guarantee**, which provides a 100 per cent guarantee of the security your bank requires for an FX facility. Once the guarantee is in place, the bank won't need to touch your operating line, so you'll have access to all your working capital. For more information, refer to EDC's guide, ***Building a Foreign Exchange Policy***.

Bonding and guarantee risk

Depending on the nature of your business, your overseas customers may expect you to provide various kinds of guarantees or bonds before they'll sign a contract. These are essentially promises that you'll complete your contract as agreed, and they provide for financial penalties if you don't. Your bank will issue the guarantee to your customers on your behalf, usually in the form of standby letters of credit (LCs).

An LC is for an amount equal to a specified percentage of the contract value. If you don't fulfil your contract, your customer can "call the guarantee" and your bank must pay your customer the value of the guarantee, as specified by the LC.

Your risk here is that the customer might issue what's called a *wrongful call*. This happens when you have in fact fulfilled all your contract conditions but the customer decides that you haven't.

Unfortunately, when the customer calls the guarantee, the bank must pay them the guarantee's cash value regardless of the merit of the call, and you'll be out the money unless you can prove the call was wrongful. Wrongful calls may result either from arbitrary action by the customer (obligor risk) or from market events that cause the customer to make the call (country risk).

This tends to be more of a hazard in emerging markets than in developed ones, but if you feel vulnerable, you can protect yourself with EDC's **Performance Security Insurance**. This covers up to 95 per cent of your losses if your customer makes a wrongful call on your guarantee.

Political Risks

As with economic/financial risk management, political risk management should include measures both to reduce the probability of the risk occurring in the first place, and to reduce its effects if it does happen. Below are the most common political risks affecting Canadian companies, together with some basic ways of dealing with them.

Changes in local laws and regulations

These changes can make it harder for you to operate in the market. If you're an exporter, for example, a change in the licensing process for your product or the imposition of tougher performance requirements may reduce your profit margins. Or, if you're setting up or operating a local affiliate, regulatory changes may make the affiliate less profitable or even render it unviable. To reduce these probabilities, you should:

- Select reputable customers and local partners with strong records of corporate and social responsibility.
- Abide by all local laws and regulations and pay close attention to your own corporate and social responsibilities in the market.

- Operate or invest in countries with which Canada has good relations or has signed a bilateral investment agreement.
- If you operate an affiliate, ensure that its relations with the local government are open and transparent, and are not disproportionately favourable to your interests (for example, when negotiating concessions or licences).

Import restrictions

For exporters, changes in import rules can make it harder and more expensive to ship goods into the market. For companies that have invested in local affiliates, new import restrictions can seriously disrupt their affiliates' operations and could even lead to the total loss of the investment. The probability of these events can be handled in the same way as the risk of changes to laws and regulations, as above.

Restrictions on moving money to Canada

If you're an exporter, these kinds of restrictions (often called currency transfer and conversion risk) may prevent you from moving your profits home to Canada, or may keep your customer from paying you. Or, if you're an investor with a local affiliate, such restrictions may keep your affiliate from making payments in hard currency back to your Canadian company, or to its suppliers and lenders.

Since this risk is usually driven by events beyond your control, it's difficult to lower its likelihood in any significant way. Your best protection here is to avoid holding cash abroad unnecessarily, and to avoid intermittent transfers of large amounts of money to Canada—instead, move smaller amounts more often. In addition, you can consider using some form of insurance (discussed below).

Breach of contract by a government

If you're an exporter selling to a local government, or if you have a local affiliate that has signed a contract with the government, a contractual breach may expose you to hazards such as non-payment, unilateral price and/or quantity changes, or outright contract termination. Moreover, if your affiliate suffers severe losses from either obligor or country risk, it may become economically unviable. To reduce this probability, you should:

- Make sure the contract was awarded in a transparent manner.
- Make sure the contract does not disproportionately favour your company (or your affiliate, in the case of a local investment).
- Diligently observe all contract obligations and all laws regulating contracts. Ensure that your contracts include clear terms on pricing, dispute resolution, termination conditions and the settlement of accounts.

Expropriation

If you're an exporter or investor, expropriation may cause you to lose your equipment or inventory in the local market. If you have an affiliate there, you may lose its income stream or even your entire investment.

Outright expropriation rarely occurs nowadays, but "creeping expropriation" can be a hazard in some markets. This is a process by which the local government slowly removes your property rights—for example, by steadily increasing taxes or by making it ever more difficult to transfer your profits back to Canada. The probability of this risk can be handled in the same way as the risk of changes to laws and regulations, as above.

If outright expropriation could be a risk, exporters should prepare contingency plans to move their physical assets outside the country if necessary, or to make these assets difficult or impossible to use if expropriated.

Political violence

If you're an exporter, political violence can prevent your local customers from taking delivery of your goods or keep them from paying you, and you may also lose your equipment and inventory in the country. If you have an affiliate, it may be destroyed or you may have to abandon it if the violence does not abate. Even if the affiliate's business is only interrupted, the affiliate or its customers may default on their payments or contractual obligations. To reduce the probability of this risk, you should:

- Select local partners and customers whose familiarity with their business and the local political situation can help you avoid trouble.
- Have contingency plans in place to move equipment and inventory out of harm's way.
- Ensure that your contracts include terms that reflect the risk of political violence.

Using insurance in political risk management

Identifying, assessing and monitoring the political aspects of your country risk can provide a high level of protection for your company. Political and economic environments can change unexpectedly, however, which underlines the need to take a long-term view of managing these risks.

Using one of EDC's **insurance solutions** can be an effective way to achieve this goal. Many of these products can be applied to various kinds of political risks, as outlined in the table below. You'll find more detail about this and much else in EDC's white paper, ***Managing Political Risk: A Guide for Canadian Businesses***.

Solution	What It Insures	Types of Political Risk Covered
Political Risk Insurance of Investments	Equity investments made in foreign countries	Expropriation, forced abandonment due to political violence, currency transfer and conversion, arbitral award default by a sovereign counterparty
Political Risk Insurance of Assets	Equipment and inventory located in foreign countries	Expropriation, forced abandonment due to political violence, damage to assets due to political violence
Foreign Funds Insurance	Cash held in foreign bank accounts	Inability to convert local currency into dollars and/or to transfer dollars out of the country
Non-honouring of a Sovereign Obligation Insurance	Loans made by banks to foreign governments or to eligible government-related entities in support of Canadian exports or foreign investments	Non-payment of the bank loan by the borrower
Contract Frustration Insurance (private sector buyers)	Contracts signed with private sector companies in foreign countries	Political violence, moratorium on debt, import and export restrictions, currency transfer and conversion, cancellation or non-renewal of licences or authorizations
Contract Frustration Insurance (public sector buyers)	Contracts signed with foreign governments or eligible government-related entities	Same as for Contract Frustration Insurance (private sector buyers), plus buyer insolvency, buyer default or contract termination by the buyer
Performance Security Insurance	The calling of eligible bonds (such as bid or performance bonds) by a foreign buyer, if the call is triggered by a covered political risk	Political violence, changes in laws, cancellation or non-renewal of licences or authorizations
Accounts Receivable Insurance (private sector buyers)	Export sales to, and export contracts signed with, foreign private sector buyers	Political violence, import and export restrictions, currency transfer and conversion
Accounts Receivable Insurance (public sector buyers)	Export sales to, and export contracts signed with, foreign governments or eligible foreign government-related entities	Same as for Accounts Receivable Insurance (private sector buyers), plus buyer insolvency or default, buyer repudiation of goods or refusal to accept them, contract termination by the buyer

PROTECTING AGAINST TRANSFER AND CONVERSION RISK: WOODBRIDGE FOAM CORPORATION

Mississauga-based Woodbridge is a major supplier and manufacturer of automotive, commercial and recreational vehicle components. Company Treasurer Joe Estriga considers transfer and conversion risk to be the firm's most likely political hazard. "Essentially," he says, "our focus is on protecting ourselves against the inability to bring cash back to Canada. We take all the steps we can to mitigate our transfer and conversion risk, but there will always be some exposure, and that's where our EDC political risk insurance comes in. It covers the part of the risk that we can't control by other means."

SUMMING IT UP

If you're doing business outside Canada, either as an exporter or via direct investment abroad, you'll inevitably be exposed to some degree of country risk. But much of this risk can be avoided, and its effects alleviated, if you have an effective risk management program. This program should have the following features:

- It should identify the probability of the risks you face in your international markets, and provide an estimate of the losses they could cause.
- It should specify how you will mitigate the effects of these risks if they lead to real-world events.
- It should routinely monitor the political, economic and socioeconomic environments of your overseas markets, and provide risk information and analyses for use throughout your company.

If you manage your country risk effectively, you can realize benefits that range from preventing financial losses to opening up new business opportunities in markets that you might otherwise have to avoid.

Financing. Asset protection. Market expertise. Risk management.

EDC can help you with all these and more:

- Need financing to grow your international business? We can help you **find it**.
- Want to protect your foreign receivables? We can help you **secure them**.
- Looking for trade and market expertise to guide you? We can **provide it.**
- Need to manage risks abroad? We can help you **control them.**

To find out more, call our Solutions toll-free number at 1-800-229-0575, or go online and **submit a question**. We'll answer your inquiries within one business day, weekdays between 9 am and 5 pm EST.

For more information, please visit **edc.ca**

Ce document est également disponible en français.

EDC is the owner of trademarks and official marks. Any use of an EDC trademark or official mark without written permission is strictly prohibited. All other trademarks appearing in this document are the property of their respective owners. The information presented is subject to change without notice. EDC assumes no responsibility for inaccuracies contained herein. Copyright © 2015 Export Development Canada. All rights reserved.

Canada

EDC

Realize a World of Opportunity