International Standards for Assessing Country Risk

A Big Boost for Business from Pricing Local Risks

by George J. Vojta and Carl F. Adams

This article presents a cogent argument for a set of international standards that can be used in pricing risk, thereby ensuring proper rewards for risks taken and better pricing for those customers and jurisdictions using best practices in their operations. The private sector has power: Use it, say the authors.

National and subnational jurisdictions use varied and unique local business behavior that may or may not conform to acceptable international "best practices." Banks that price for distinctions in lending, trading, investing, custody, and financing services—using valid accounting for the risks inherent in the institutions and the practices within local jurisdictions—can realize an enduring boost for business, competitive advantage, and fiduciary protection.

Pricing for country and local risk is a unique power reserved only for the biggest force in world capital markets—the private sector. And risk managers have an obligation to assume leadership in recognizing and using this power.

The Financial Standards Foundation seeks to serve as advocate for the private sector's leading role in pricing for country compliance with international financial standards. Currently, there is no global sovereign power or regulator to enforce compliance with standards and codes of best practices, as can be seen in the numerous offshore activities and off-balance-sheet vehicles in use. However, the natural laws of economics, and the consensus of civil societies acting in their own self-interests, do set global financial limits—again, guided by market prices that even the mightiest sovereign superpower must respect! The private sector can harness this reality with sharper, more informed pricing of commercial risks.

It's perfectly logical. Why would any good risk manager tolerate holding financial risks for which his or her firm is not fully paid? Why would any financial professional fail to exploit the ability to deliver less costly financial products and services to less risky clients for competitive advantage? Yet in the current geopolitical seizures of global financial markets, most of the private-sector players fail to charge risk premiums for products and clients in countries where the risk of global

 George Vojta is senior director of the Financial Services Forum, an association focusing on regulatory, legislative, and public policy issues related to the global financial system. He is a former vice chairman of Bankers Trust and former executive vice president for strategic planning at Citicorp. He is a director of Private Export Funding Corporation; a member of the Council on Foreign Relations; a member of the New York State Banking Board; and chairman of the board of the Wharton Financial Institutions Center at the University of Pennsylvania. Carl Adams is president of the Board of Governors for the New York City Chapter of RMA—The Risk Management Association. He also is co-chairman of the Credit & Risk Steering Committee of The Bond Market Association. He currently serves as a senior director for the NY-based Capital Markets Credit Analysts Society and is a senior consultant to both public and private institutions on issues of country analysis, risk management, and government relations.

architecture conformity is very great. They also fail to discriminate and discount products and clients where the risks of global architecture compliance are measurably very low and going down!

Weak prices and low demand in financial markets during the past few years suggest that competitive pressures are not the reason for missed business growth from global financial architecture. Rather, it's the private sector's lack of awareness that country compliance with international standards and codes can be a potent, positive business tool.

A Starting Point for International Standards & Codes

The private sector *can* use its power and authority to demand compensation for the risk assumed from financial exposure to contracts and business risk in countries that do not comply (or refuse to acknowledge any intention to comply) with global policy standards. While there are no global regulations or sovereign disciplining authorities, global standards do exist for best practices and infrastructure competence required to sustain capital markets and prudent but effective finance.

A good starting point for a list of such standards has emerged from efforts by the official sector since the early 1990s. The policy standards for best business behavior are outlined by the Financial Stability Forum of the Bank for International Settlements (BIS). Both the science and the art of global financial architecture are contained within the guidelines of these principles, which are based on work by the global public sector, by international financial institutions, and by global self-regulatory professional associations. (See Appendix, "Key Codes and Standards for Sound Financial Systems.") The 12 policy standards fall into three topic categories as follows:

Macro Fundamentals

1. Transparency in monetary and fiscal policies.
2. Fiscal disclosures.
3. Special data dissemination standard.

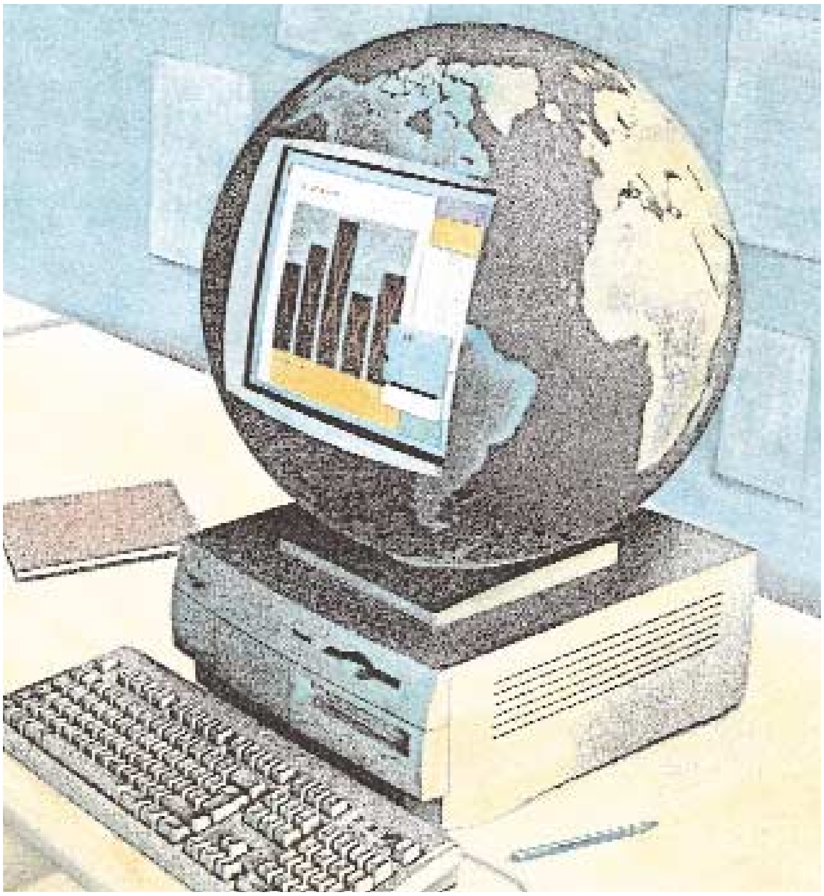
Institutional and Market Infrastructures

4. International accounting standards.
5. International auditing standards.
6. Principles of corporate governance.
7. Insolvency guidelines for enterprise bankruptcy, recovery, and/or liquidation.
8. Core principles on payment and settlement systems.
9. Money-laundering rules for market integrity.

Financial Regulation and Supervision

10. Core principles for banking supervision.
11. Objective rules of securities regulation.
12. Supervisory principles for insurance oversight.

With such a complete list of international standards (and there are explicit principles for each), the question might be, Why aren't businesses using this checklist, determining differences of risk from country to country according to the country's compliance with these standards, and then pricing for such risk with the powerful and positive results suggested



THERE STILL IS NO UNIVERSAL ACCEPTANCE BY ANY COUNTRY THAT COMPLIANCE WITH RULES AND BEHAVIORS CONDUCIVE FOR GLOBAL FINANCIAL MARKET BEST PRACTICES ARE COST EFFECTIVE AND POLITICALLY/SOCIALLY BENEFICIAL.

above? For a possible answer, check your own awareness of this topic and these 12 international standards and codes:

- Have you heard of these issues before?
- If so, do you know whether countries comply with all of the standards?
- If you don't know, do you know where and how to look for indications of compliance?
- Do you know whether the U.S. fully complies with all 12 standards and codes?

Evidence suggests that few in the private sector know of these standards and codes, and of those who do, very few have any realistic method to access public information confirming any country's compliance with all of these standards. Just as one example, did you know that the answer to the last question is that the U.S. does *not* comply with all 12 standards and codes? The first problem with the list of 12 standards and codes for international country compliance, then, is low awareness and obscure sources of information.

A second problem is that for these standards and codes to be meaningful, countries themselves must acknowledge and agree with their importance. There still is no universal acceptance by any country—industrially advanced, developing, highly indebted, or poorest of the poor—that compliance with rules and behaviors conducive for global financial markets' best practices are cost effective and politically/socially beneficial. This is an important phenomenon that market pricing and economics can fully address *if* the private sector empowers these codes and standards by adopting them and using them discriminatingly.

A third problem for these standards and codes is that they are macroeconomic in nature and fail to address causes that are microeconomic and financial sector specific. While valid, however, this issue is directly addressed by the micro nature of business risk discrimination in the context of or reference to country level compliance (or stated ambitions for compliance) with the 12 standards. Active use by the private purse to price risks of compliance or noncompliance in a country (a microeconomic application) would translate very quickly into reform and improvement of the global financial architecture—itself a macro structure.

Finally, a major cause for trouble with these standards and codes is the previously mentioned lack of uniform accountability and lack of valid or reliable enforcement of their adoption and implementation. This problem, like the three problems before, is directly resolved by private-sector pricing for country risk. The power of the market when it is fully informed and aggressively rewarding standards of best practice in the global financial architecture is the least emotional and most honest process for allocation of risk and its fair returns.

So what do we do, and how can business use and benefit from its "power in the markets" to grow and reshape the global financial architecture? The answer lies in education, investigation, discrimination, and valuation.

Education—increase awareness of these international standards and codes; the issues unique for each country that they profile; and the commercial opportunities that a broader, deeper familiarity with any national or subnational jurisdiction will deliver.

Investigation—chant the mantra of *thorough due diligence* for each business agenda as it examines commercial opportunities in a given location against the outline of the 12 standards and codes of universal best practice.

Discrimination—assign and price for the differences, both positive and negative, that are evidenced by the education and investigation of your own enterprise agenda.

Valuation—price your products and services according to the discrimination judgment for fair and honest returns on identifiable risks from compliance and noncompliance with the global standards of best practice.

This prescription summarizes the goal and ambition of a not-for-profit, private initiative—the

Financial Standards Foundation (see sidebar). The central belief of this foundation is that a strong, prosperous flow of private capital available for sustainable development of a national and subnational jurisdiction is the single best contributor to improved human welfare in all locations. The "power of the private purse" and its underutilized leverage and influence in the global financial architecture is a worthwhile objective for successful business, for healthy competition, and for a better world. The philosophy of transparent disclosure is the foundation's central theme by purpose and is based on its founder's and principals' considerable experience with banking and capital markets since the early 1960s.

To promote the recommendations for education, investigation, discrimination of risk, and the empowerment of pricing for country compliance with international standards and codes, the Foundation provides a Web site for the marketplace with information and disclosure of country behaviors. This service, delivered by the Foundation's fully owned organization, eStandards Forum, posts public evidence and evaluation of 83 countries' compliance with all 12 standards and codes, their degree of compliance on a uniform and objective register, and a numeric index of compliance for reference and ranked comparison by standards and among countries. This database of information is slated to be expanded to cover a total of 183 national jurisdictions.

The information on the eStandards Forum Web site (see Note at conclusion of article) is freely available to all market participants who register to use its resources. Suggestions for using this resource illustrate the potential for business success, the competitive opportunities it might underwrite, and the power for influence on the global financial architecture it accrues to the private sector. For example, the most recent numeric index for the 83 countries evaluated by eStandards Forum shows that two very wealthy but small national jurisdictions possess compliance risks not evident from their national accounting and external debt ratings. A few of the interesting findings include the following:

- *Singapore* scored 26.15 out of a possible 100 (full and complete compliance with all 12 international standards) and ranks 50th on the 83-country list.
- The score for Singapore ties with *Thailand* and *Indonesia*.
- The *United Arab Emirates*, exceptional oil wealth notwithstanding, ranks 55th out of 83 with a score of 20 out of 100. While this may seem low for such a rich country, it must be noted that UAE's compliance only recently improved to this level from last place with the recent release of the IMF's Financial Sector Assessment Program (FSAP) report.
- For those risk managers familiar with *Brazil* and *Argentina*, the public records reveal that both countries have some gaps in compliance with global standards and codes. It may be useful, how-

Financial Services Foundation Mission Statement

The Financial Services Foundation (FSF) seeks to promote the conditions for meaningful, dignified, and sustained enrichment of human welfare through economic growth, public policy transparency, and social policy integrity. We believe that the mobilization of private capital, invested prudently in healthy, transparent markets, reaps lasting benefits for a country's people, prosperity, and positive integration with the global community.

To pursue this mission, we will support programs that promote adherence to global best practices and international standards in a framework of 12 core areas of business behavior. The 12 areas are grouped into three categories:

- Macroeconomic Policies as portrayed by a country's publicly available information and statistics.
- Financial Infrastructure and Market Discipline as evidenced by independent observations of enterprise management in the country and by verifiable compliance with best practices.
- Regulation and Supervision of a country's financial system with regard to independent verification and prudential, transparent oversight.

Our programs will encourage public-sector leaders to commit to real reform in business management. FSF programs will strive to provide private-sector interests worldwide with an accurate picture of a country's true economic growth potential, thereby enabling prudent and profitable risk discriminations and stimulating responsible business commitments. Our programs will also support the work of training and technical assistance providers in a country engaged in developing the requisite human capital in public and private financial institutions.

> **THE RISK MANAGER'S SUPPORT OF LINKING PRIVATE MARKETS TO COUNTRY COMPLIANCE WITH STANDARDS AND CODES OF GOOD BEHAVIOR IS THE KEY REQUIREMENT. IT IS ALSO A MANDATE FOR LEADERSHIP.**

ever, to note as well that Argentina—even after bankruptcy of record proportions—ranks 33rd out of 83 while Brazil ranks 48th. Further distinguishing the assessment, Argentina scored 39.23 out of 100; Brazil scored 27.69 out of 100.

Scores and ranks for these countries suggest that risks from compliance with the global financial architecture may be an additional and unique screen for assessing country risk and, most importantly, for pricing the terms of exposures in these jurisdictions.

Other examples highlight risk assessment complexities among the more industrially developed countries. There is no country among the 83 states that scores a perfect 100. The *United States* does score highest, ranking first with a numeric index of 83.08 out of 100. There is useful business risk consideration, however, when the U.S. is compared with *Canada*, which ranked fifth but scored 19 points less at 64.62 out of 100. There are no arguments that both countries mostly comply with international standards and codes. Neither G-7 country posts perfect scores; both have recent evidence of problems with several principles among numerous specific standards.

Business risk mining in this analytical space might well turn up exploitable, competitive, and profitable insight for commercial returns. Similar suggestions are found in the reporting that France ranked 13th out of 83 with a score of 53.85 out of 100. The United Kingdom ranked fourth out of 83 with a score of 66.92; Germany ranked 20th out of 83 with a score of 47.99. eStandards Forum posts a numeric index of 70.00 out of 100 for Hungary and a ranking of third out of 83.

The Financial Standards Foundation believes that transparency is the force leading to proper risk discrimination and the ability to assign fair and market-clearing prices for businesses conducted increasingly on a global platform. The eStandards Forum Web site offers a timely and novel approach to global architecture assessments focused on financial sector reform and the best practices of the private sector. There are power and leverage in the risk management function—an influence that can be truly positive for world business behavior if practitioners are willing and able to follow the prescription for boosting business from global financial architecture. The risk manager's support of linking the private markets to country compliance with standards and codes of good behavior is the key requirement. It is also a mandate for leadership.

The Financial Standards Foundation emphasizes the urgency of compliance with global business standards and codes of good behavior as a primary requirement of the private market participants. Pricing the risks of country compliance with global architecture reality is a mandate for us all. The power of pricing will be a positive enforcement of country compliance for the benefit of the country's own population. Welcome to the 21st century! ❐

Note

For access to the information Web site of eStandards Forum, a wholly owned initiative of the Financial Standards Foundation, please contact Matthew Zimmer at matt.zimmer@eStandardsForum.com *The Financial Standards Foundation is a Delaware-registered, not-for-profit organization*.

Suggested Reading

Dominic Barton, Roberto Newell, and Gregory Wilson, *Dangerous Markets, Managing in Financial Crises* (John Wiley & Sons Inc., New York, 2002), ISBN 0-471-22868; HD 49.B367, p. 294.

Michel Cardona and Marc Farnoux, "International Codes and Standards: Challenges and Priorities for Financial Stability," *Financial Stability Review; No. 1*, November 2002, Banque de France,\ ISSN en cours 109-0001, p. 143. (www.banque-france.fr)

Lodge, George J., "Using Big Business to Fight Global Poverty," *Foreign Affairs*,. July/August 2002, Vol. 81, No. 4, pp. 13-18.

Vojta, George J., "Global Standards: The Path to An Improved Global Financial System," *Central Banking*, Vol. XII, No. 01, August 2001.

Vojta, George J., "Why the Private Sector Must Consider Standards," *The Financial Regulator*, Vol. 7, No. 3, December 2002, pp. 40-45.

Financial Stability Forum at the Bank for International Settlements, www.fsforum.org.

1. The Task Force on the Implementation of Standards, established September 1999, chaired by A. Sheng (Securities and Futures Commission of Hong Kong), published March 2000.
2. The Follow-Up Group on Incentives to Foster Implementation of Standards, set up in April 2000 and chaired by A. Nawrath (German Ministry of Finance), published August 2001.

Appendix

Key Codes and Standards for Sound Financial Systems

	Area	Key Standards	Issuing Body	Dates Formulated
Macroeconomic Policy and Data Transparency				
1	Monetary and Financial Policy Transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	International Monetary Fund (IMF)	1999
2	Fiscal Policy Transparency	Code of Good Practices in Fiscal Transparency	IMF	1998
3	Data Dissemination	Special Data Dissemination Standard (SDDS) General Data Dissemination System (GDDS) (a)	IMF	1996/1997
Institutional and Market Infrastructure				
4	Insolvency and Creditor Rights	Principles & Guidelines for Effective Insolvency Regimes and Creditor Rights Systems	World Bank	2001
5	Corporate Governance	Principles of Corporate Governance	OECD	1999
6	Accounting	International Accounting Standards (b)	International Accounting Standards Committee (IASC) (note c)	Since 1974
7	Auditing	International Standards on Auditing (ISA)	International Federation of Accountants (IFAC) (note c)	
8	Payment & Settlement	Core Principles for Systemically Important Payment Systems/Recommendations for Securities Settlement Systems	Committee on Payment & Settlement Systems (CPSS) International Organization of Securities Commissions (OSCO)	2001
9	Market Integrity	The 40 FATF recommendations on money laundering & 8 special recommendaitons on financing terrorism.	Financial Action Task Force (FATF)	1990 (revised in 1996 & 2001)
Financial Regulation and Supervision				
10	Banking Supervision	Core Principles for Effective Banking	Basel Committee	2001
11	Securities Regulation	Objectives and Principles of Securities Regulation	OSCO	1998
12	Insurance Supervision	Insurance Core Principles	International Association of Insurance Supervisors (IAIS)	2000

Notes

(a) Economies with access to international capital markets are encouraged to subscribe to SDDS; all other economies are encouraged to adopt the GDDS.
(b) These standards are currently being reviewed by the IASC and IOSCO.
(c) IASC and IFAC are private-sector bodies.

Source: Financial Stability Forum