Perception Versus Reality:
Why Differing Views of Risk Matter

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The Risk Assessment Challenge

- Getting good data is relatively easy
- Assessing data involves more than just collecting information
- Accurate interpretation of the data is the challenge
- Perception of risk versus reality of risk

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Sound Risk Assessment

- Subjective process
- Qualitative in its orientation
- Analytical process varies by organization
- Spread of Risk concept
- Common Sense
- Gut Feeling/Smell Test

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Information Resources

- On-site data collection
- Newspapers, magazines, newsletters
- Specialty publications
- Internet search engines
- Embassies-Departments of Commerce/State
- EIU, Control Risks, Kroll
- ADB/World Bank/IMF Reports

Common Investor Misperceptions

- "It's a slam dunk"
- It won't happen to me
- If it happens, there will be an easy solution
- If there isn't an easy solution, I can 'buy' my way out of it
- Once the problem is solved, it's solved for good

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International Center for the Settlement of Investment Disputes

- 86 cases concluded between 1972 and 2003
- 86 cases pending
- 15% increase in cases over 2003
- 50% of these are infrastructure-related
- Conclusion: More disputes remain unresolved, and more deal with infrastructure than ever before

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Common Insurer Misperceptions

- It can’t be done
- You’ve got to be crazy?! Are you out of your mind?! He’s gone bonkers!!
- There will be hell to pay

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Misperception 1: Pakistan

- ADB's Terrorism Guarantee Facility For Pakistan
- Presumption going in was that:
  - Pakistan was uninsurable against terrorism/political violence risk
  - Few insurance underwriters would want to co/re-insure because of the perceived risk
  - Few entities would want to invest in Pakistan in the first place

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Reality 1: Pakistan

- Commercial loss due to acts of terrorism in Pakistan is actually very low
- Lots of insurers want to participate in the program
- Plenty of entities want to invest there

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Misperception 2: Israel

- U.S.-based major fast food franchise opens franchise in what they believe is Israel
- It turns out to have been the West Bank
- It asks the local franchiser to remove the company's name brand from the premises and stop serving kosher hamburgers
- Franchiser refuses to do so
- Arab-American groups protest establishment of the franchise on the West Bank

Misperception 2: Israel

- Issue becomes international incident
- Threatened boycott of franchise in Arab world follows
- Franchise is closed
- Jewish groups accuse company of capitulating to Arab pressure, promising their own boycott

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Reality 2: West Bank

- Franchise home office did not perform a site visit
- A company inspector subsequently viewed the premises, but was unaware its was located on the West Bank
- Investment should never have been made. Adequate due diligence was not performed. Common sense was not utilized.

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Misperception 3: Korea

- Korea's leading software maker was near bankruptcy
- U.S. company sees golden opportunity, proposes to save it by making a $20 million investment
- Korean company has to in return agree to stop producing a highly popular Korea language processing software (80% of the market) and start selling US company's version of the software (15% of the market)

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Reality 3: Korea

- U.S. company didn't do its homework and take into account Korean nationalism
- Korean press got hold of the story, local company pulls out of the deal and accepts a smaller bailout from a local firm
- Korean company ends up filing charges against U.S. company accusing it of attempting to gain market share illegally

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Misperception 4: Russia

- Russia's largest foreign investor, a U.S. oil company, felt it had the knowledge and experience necessary to maneuver its way through the Russian political system
- It invests $500 million in a Russian oil company, with plans to invest another $3 billion in time
- U.S. company accuses local company's rival of tampering with Russia's court system to gain control of its partner's main production facility

Misperception 4: Russia

- Rival’s objective was to force U.S. company’s partner to have to declare bankruptcy
- Rival purchases part of U.S. partner’s debt, becoming a part-owner in it
- As a result, the rival votes against an amicable settlement with creditors, forcing bankruptcy
- U.S. company is forced to write off $200 million

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Reality 4: Russia

- U.S. company started with too small of an ownership stake in the local company (just 10%)
- It had little decision-making influence
- Two lenders were not properly registered as creditors, preventing them from supporting the U.S. company
- The owner of the U.S. company's partner lost his political influence in the government
- The U.S. company was forced to make its own way through the court system

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Some General Guidelines

- Does it smell right?
- Does it ‘feel’ right?
- Does it make sense?
- Can you afford to have something go wrong?
- Do you have any protection if things go wrong?
- Has a scenario analysis been completed?

Some Specific Guidelines

- Get Political Risk Insurance
- Ensure you know your business partner, and have them checked out first by an independent party
- Ensure arbitration takes place outside the host country, preferably in a neutral forum
- Ensure third country rule of law
- Ensure the host government waives its right to sovereign immunity
- Develop relationships with key government officials

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Loss Mitigation

Keys to low loss ratios:

- Know when to say “no”
- Ensure that there is a means of recovery:
  - Subrogation rights
  - Pari Passu rights vis-à-vis senior lenders
  - Leverage with host government
- Don’t be afraid to be bold

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