

# F O C U S: Risk – A Fuller Picture

## Issue in a Snapshot

*A recent slew of sovereign rating downgrades has stoked concerns...*

*...heightening investor risk aversion towards the euro zone and weakening economic prospects.*

*However, sovereign risk is only one aspect of the risk of doing business...*

*...and many other risk factors can affect firms' investment and trade exposures.*

*To gain a full picture, businesses need to assess much broader measures of risk...*

*...otherwise they run the risk of missing out on opportunities...*

*...or leaving themselves exposed to risks not captured by sovereign ratings.*

*The recent mass sovereign rating downgrade of nine euro-zone countries signalled a rising risk of debt default in such countries. However, sovereign risk is only one component of the risk of doing business. Non-financial corporations should look at much broader measures of country risk: the key political, economic and commercial risks that can affect trade and investment returns when doing business in a country.*

### **Sovereign rating downgrades stoke concerns**

In January, international credit ratings agency S&P downgraded the long-term foreign- and local-currency government bond ratings of nine euro-zone countries, including two of the region's six top-rated countries, France and Austria. Following in the footsteps of other global ratings agencies, S&P also downgraded Portuguese and Cypriot government bonds to 'junk' status, joining Greece in that category: S&P now has three euro-zone countries below investment grade, effectively shutting them out of the wholesale funding markets. The ratings agency also went further, downgrading the long-term credit rating on the euro-zone's bailout package fund, the European Financial Stability Facility (EFSF).

Significantly, the rating downgrades will heighten investor risk aversion towards the euro zone, weakening economic prospects. Similarly, the downgrade of the euro-zone's bailout fund will stoke problems for the euro area as a whole; it will increase borrowing costs for the EFSF, making it difficult for it to meet its existing commitments.

### **Commercial implications**

Developments in the nine euro-zone countries recently downgraded by S&P matter in the financial markets, as contagion from debt markets can spread quickly to equity and credit markets, undermining corporate funding and profitability. However, it is important to note that the kind of risk that financial markets and the sovereign credit rating agencies are worried about (sovereign risk) is only one aspect of the risk of doing business. Indeed, sovereign rating agencies are primarily concerned with whether a country will be able to service its debt. This matters particularly to the financial sector (banks, pension funds etc.) which is exposed to sovereign debt directly.

### **A fuller picture of risk**

Apart from sovereign risk there are many other risk factors that can affect firms' investment and trade exposures. Non-financial corporations need to look at much broader measures of country risk (the key political, economic and commercial risks) as part of their decision-making processes on exporting or investing in a country.

For example, Spain and Italy's recent downgrades to lower investment grades does not mean that it is suddenly more risky to do business in Spain and Italy as such; in fact, sovereign credit risk downgrades tend to be lagging indicators and do not necessarily give an accurate picture of whether business risk has increased or decreased. Key indicators not captured by sovereign credit ratings include: companies' payments performance; company insolvency risk/non-payment risk; prospects for domestic demand and thus for exports to the country; political stability; and many more. Moreover, the broader commercial and trading framework (taxation, administrative barriers to trade, investment incentives etc.) is not embodied in the sovereign risk rating.

Sovereign risk also says little about business opportunities: Spain still has a favourable trading environment, with economic activity in the industrial sector continuing to expand, while export performance underlines still favourable external demand for the country's resources (highlighting opportunities for companies doing business with the export sector). Likewise, Italy's services sector has recorded sustained growth and the country has recently reduced its primary budget deficit (before interest payments).

Sovereign risk ratings should not be the sole guide for making decisions about business operations: bearing in mind the additional factors affecting business risk, a number of potentially lucrative business opportunities remain open in these countries. Moreover, many other risks are simply not captured by sovereign risk ratings.