Doing business in high risk countries

Attractive investment and growth opportunities are often found in countries with high levels of risk. As such, companies need to make sufficient preparations, write Elena Hounta and Selen Lehmanna of the Basel Institute on Governance.

The Global Financial Integrity (GFI) report titled Illicit Financial Flows from Developing Countries: 2003-2011 states that, in 2012 alone, almost $3tn of illicit funds left developing countries. Stemming from a variety of illicit origins, such as trade misinvoicing, tax evasion, trading in illegal goods and corruption, illicit funds represent a huge loss to developing countries and their populations. They also represent a major risk for financial centres and their banks and non-banking financial institutions, and for companies involved in international investment and trade.

The dual nature of this phenomenon neatly illustrates the complexity associated with doing business internationally and managing associated risks. Risks emanate on the one hand from the countries in which illicit flows originate, where risks would be associated with high levels of financial and economic crimes and limitations in relation to the rule of law. On the other hand, risks relate to the international flow of funds and the embarrassment of having an altogether changing landscape of financial centres, no longer situated only in developed countries but increasingly also in the ‘global south’, adds to the complexity. Defining a ‘high risk’ country is thus becoming increasingly complex, and this represents a major challenge for companies and financial institutions.

Illicit cash flow

Countries from which a majority of the illicit flows originate are systematically accused of having a weak legal framework to prosecute criminals, whether they are locals or international companies or their representatives. In particular, they have little to no experience in handling complex international crimes or in following the money. This, in turn, quickly lead to the belief that doing business in these countries is only a risk on paper. However, the contrary is true.

The global reach of national laws against corruption and related crimes, such as the US Foreign Corrupt Practices Act (FCPA) or the UK Bribery Act, but the operations of almost any internationally operating company under close and growing scrutiny. In addition, the implementation of international money laundering standards, such as those of the Financial Action Task Force (FATF), mean financial institutions are being seen as frontline defenders in the fight against money laundering and gatekeepers of the financial system’s integrity. Ignoring country risks is thus an option.

Risks are usually specific to each country, its political and economic structure, and to each industry: By way of example, industries that are susceptible to high levels of corruption are oil and gas, defence, logistics, telecommunications and pharmaceuticals. Gaining access to or staying in their markets often involves large public procurement and licences issued by state authorities, the size of contracts involved is such that winning or losing a contract may in some cases decide on the fate of a company, while gains potentially to be made by concerned public officials through kick-back schemes are too small to be ignored. This is a formal statement however, and generalising it across all countries in the world likely means that we are simplifying reality and neglecting the complexity in all countries in the world likely means that we are simplifying reality and neglecting the complexity in just how to manage these risks. Identifying the risks can be useful from a prevention as well as business perspective, for instance, in allocating compliance resources appropriately to where the risks are greatest (due to the limited resources – even larger companies), in identifying countries and businesses that could cause harm before it is too late, and identifying poor business prospects, such as customers who pose sanctions and export-control risks, after taking into account the regulatory risks they introduce.

Assessing risk

In order to ensure meeting the increasing ethical and legal requirements to operate in foreign countries, most of the financial institutions and companies have established sophisticated internal compliance systems. Within the compliance community it is well known that the foundation of any compliance system is an initial and ongoing risk assessment in order to identify, assess, monitor and manage risks, including financial crime and money laundering risks associated within a business sector.

The starting point of the risk assessment process is usually identifying the environment(s) in which the business operates. A key factor affecting this is related to country specific characteristics. Beyond the country risk, further risks analyses are necessary and may include third party, sector and transaction risks in order to identify more specifically the business areas that are more exposed to financial crime risks than others.

Identifying countries with respect to their exposure to financial crime and money laundering, is however, challenging, giving the lack of a pre-configured formula to assess these risks at a country level. To date there has been no universally agreed definition or methodological approach that clearly defines whether a particular country represents a high risk. Companies and financial institutions suddenly face the task of assessing countries’ risk by investing in their own research, experts and methodology to develop a risk-rating tool.

While larger companies may cope with such resources-heavy measures, small- and medium-sized companies that operate globally are less capable of conducting such a task. A cost-efficient solution for the companies, which do not have the resources to assess country risks, can be to use a commercial rating system. A valid country risk assessment should, however, rely on credible sources and needs to be developed independently without the influence of profitability or political considerations.

Through the Basel AML Index, the Basel Institute on Governance has managed to develop a solid and independent methodology to identify the relative risk level of countries in money laundering and terrorism financing. The Basel AML Index provides a composite index of engagement, the index is based on six different sections (see Fig. 2) and addressing a range of topics that affect money laundering.

Risks are usually specific to each country, its political and economic structure, and to each industry. In countries with respect to their exposure to financial crime and money laundering, is however, challenging, giving the lack of a pre-configured formula to assess these risks at a country level. To date there has been no universally agreed definition or methodological approach that clearly defines whether a particular country represents a high risk. Companies and financial institutions suddenly face the task of assessing countries’ risk by investing in their own research, experts and methodology to develop a risk-rating tool.

While larger companies may cope with such resources-heavy measures, small- and medium-sized companies that operate globally are less capable of conducting such a task. A cost-efficient solution for the companies, which do not have the resources to assess country risks, can be to use a commercial rating system. A valid country risk assessment should, however, rely on credible sources and needs to be developed independently without the influence of profitability or political considerations.

Through the Basel AML Index, the Basel Institute on Governance has managed to develop a solid and independent methodology to identify the relative risk level of countries in money laundering and terrorism financing. The Basel AML Index provides a composite index of engagement, the index is based on six different sections (see Fig. 2) and addressing a range of topics that affect money laundering.

The results show that the countries on top of the high risk ranking of the Basel AML Index (see Fig. 2) all sit in a weak jurisdiction, a lack of resources to control the financial system, and a lack of public and financial transparency.

The Basel AML Index illustrates that a combination of weak AML/CTF frameworks and a generally low performance in the majority of indicators that have been used in the ranking result in a high overall risk score. This may explain why particularly developing or low-income countries have been at the top of the Basel AML Index for the past three years. Among OECD countries, Austria, Germany, Luxembourg, Japan and Switzerland still rank above-average high risk despite legislative progress and low rates of perceived corruption (see Fig. 3). The reason being that Austria, Germany and Switzerland can be considered as major financial centres, or the sophistication of their economies.

Mitigating risk

The Basel AML Index (such as the Basel AML Index Expert Edition) is important for financial institutions and companies to understand the weaknesses and blind spots of the AML/CTF framework and to implement effective measures that complement the national laws and address the gaps.

Risk mitigation does not mean or require the elimination of all risks – that’s simply not feasible. But it can mean making an informed choice between leaving a market or taking measures that allow the company to remain in that market at a minimised risk level. Establishing an effective and appropriate compliance/counter terrorism financing (AML/CTF) programme has been detected.

Defining a risk appetite based on a comprehensive approach that takes into account both the size of a company and its exposure to financial crime and money laundering risks associated within a business sector. A comprehensive risk appetite framework can be developed independently without the influence of profitability or political considerations.

The starting point of the risk assessment process is usually identifying the environment(s) in which the business operates. A key factor affecting this is related to country specific characteristics. Beyond the country risk, further risks analyses are necessary and may include third party, sector and transaction risks in order to identify more specifically the business areas that are more exposed to financial crime risks than others.

Identifying countries with respect to their exposure to financial crime and money laundering, is however, challenging, giving the lack of a pre-configured formula to assess these risks at a country level. To date there has been no universally agreed definition or methodological approach that clearly defines whether a particular country represents a high risk. Companies and financial institutions suddenly face the task of assessing countries’ risk by investing in their own research, experts and methodology to develop a risk-rating tool.

While larger companies may cope with such resources-heavy measures, small- and medium-sized companies that operate globally are less capable of conducting such a task. A cost-efficient solution for the companies, which do not have the resources to assess country risks, can be to use a commercial rating system. A valid country risk assessment should, however, rely on credible sources and needs to be developed independently without the influence of profitability or political considerations.

Through the Basel AML Index, the Basel Institute on Governance has managed to develop a solid and independent methodology to identify the relative risk level of countries in money laundering and terrorism financing. The Basel AML Index provides a composite index of engagement, the index is based on six different sections (see Fig. 2) and addressing a range of topics that affect money laundering.

The results show that the countries on top of the high risk ranking of the Basel AML Index (see Fig. 2) all sit in a weak jurisdiction, a lack of resources to control the financial system, and a lack of public and financial transparency.

The Basel AML Index illustrates that a combination of weak AML/CTF frameworks and a generally low performance in the majority of indicators that have been used in the ranking result in a high overall risk score. This may explain why particularly developing or low-income countries have been at the top of the Basel AML Index for the past three years. Among OECD countries, Austria, Germany, Luxembourg, Japan and Switzerland still rank above-average high risk despite legislative progress and low rates of perceived corruption (see Fig. 3). The reason being that Austria, Germany and Switzerland can be considered as major financial centres, or the sophistication of their economies.

Mitigating risk

Using a solid country risk ranking (such as the Basel AML Index Expert Edition) is important for financial institutions and companies to understand the weaknesses and blind spots of the AML/CTF framework and to implement effective measures that complement the national laws and address the gaps.

Risk mitigation does not mean or require the elimination of all risks – that’s simply not feasible. But it can mean making an informed choice between leaving a market or taking measures that allow the company to remain in that market at a minimised risk level. Establishing an effective and appropriate compliance/counter terrorism financing (AML/CTF) programme has been detected.