Reading

A senior risk analyst works for a nation's sovereign wealth fund (SWF). She is attending an investment committee meeting in which a proposed investment in direct private equity is being discussed. Details of the investment are below:

- The SWF will take a 40% stake in unlisted foreign automobile manufacturer Dala Motor Group (DMG), based on the island nation of Modinica. The proceeds from the investment will be used to increase the automation and robotics of the company's plant and machinery. This investment should improve productivity, leading to an expected reduction in headcount of up to 40% of the current staff.

- DMG has benefitted historically from large tariffs on imported cars from large international automobile manufacturers. If the governing party in Modinica changes, it is expected these tariffs will be reviewed and potentially reduced or even removed. This could lead to a reduction in demand for DMG automobiles in favor of the now lower-priced imports.

- Existing DMG management will remain in place after the investment. Management has recently been issued a fine by the government of Modinica for inadequate waste disposal measures leading to the pollution of local wetlands.

The head of risk at SWF raises issues regarding currency risk, business competition risk, and risks relating to the quality of the existing management team with the head of private equity. The head of private equity makes the following comments in response:

- "With respect to currency risk, we shouldn't be too concerned here. The currency of Modinica is pegged to the USD, and this is expected to continue. Apart from a currency crisis in the late 1990s, which occurred prior to the peg to the USD, there has never been an issue with the currency of Modinica.

- With respect to business competition risk, we shouldn't be too concerned about the impact of the potential removal of tariffs—the domestic customers of DMG are very loyal to the brand, so international automobile makers are not really competitors to DMG.

- I don't see any risk with the existing management team—they've shown themselves to be tremendously effective cost-cutters in recent years. I'm sure they can go on to cut the staff by even more than our target and reduce all sorts of costs and perks for the staff!"

The head of risk is unimpressed by the responses of the head of PE and points out that none of the risks mentioned have been adequately assessed.

Question 1.1

Recommend how the risk management of the currency risk can be improved.

Scoring Guide:

4 points for the appropriate recommendation

Explanation:

Model Answer

Currency risk should be assessed using a scenario analysis that presents the probability and impact of Modinica's currency depreciating. This should include a stress test involving the removal of the peg to the USD. Risk analysis should also consider the reasons behind the currency crisis in the 1990s and whether these conditions are likely to repeat.

Question 1.2

Recommend how the risk management of the business competition risk factor can be improved.

Scoring Guide:

4 points for the recommendation

Explanation:

Model Answer

Scenario analysis should be carried out, presenting the probability of a new government lowering tariffs and the potential impact on the profitability of DMG. The extreme scenario of tariffs being dropped completely, with a shift in brand loyalty to foreign car manufacturers, should also be incorporated into the analysis.

Question 1.3

Discuss the major risk factor associated with working with the current management team at DMG.

Recommend how this risk factor can be best managed if the fund proceeds with the investment.

Scoring Guide:

2 points for discussing the major risk factor

2 points for recommending how the risk factor can be managed

4 points total

Explanation:

Model Answer

The current management team at DMG exhibits a poor track record on environmental issues by cutting corners in disposing of waste materials and receiving a fine from the local government. They also have a track record of aggressive cost cutting, which seems to be endorsed by the head of PE at SWF. There is a risk this could go too far and cause severe dissatisfaction among the workers, thereby reducing the quality of factory output. Layoffs are also a serious social issue that could lead to unemployment on the island. These environmental and social issues contribute to reputational risk for SWF. The fund's ability to make the investment work, and to continue investing successfully in similar projects, may be impaired by reputational damage from the investment in DMG. SWF should work with the current management team at DMG to educate them on the long-term negative consequences of focusing on short-term profits at the expense of the environment and their staff's working conditions. To address potential reputational risk, SWF should suggest that DMG offer retraining or compensation payments to employees who are laid off or help them to find new employment as a way of mitigating the impact of the planned layoffs on the island population.

Reading

Ola Ramil is a senior risk analyst for a nation's sovereign wealth fund (SWF). Ramil is attending an investment committee meeting in which a proposed foreign direct investment in infrastructure is being discussed. Details of the proposed investment are as follows:

- The investment is a new toll bridge for a river crossing just outside a major foreign capital city. The fund will contribute 25% of the capital required, the local government will contribute 15%, and the rest of the project will be funded with fixed-rate infrastructure project bonds guaranteed by the foreign government.
- The agreement between the SWF and the foreign government states that the SWF is responsible for the construction and maintenance of the bridge. A pre-agreed fixed payment will be made by the government to the SWF in local currency for every month that the bridge is operational after a two-year construction period, regardless of the level of usage. The agreement in total covers the next 10 years.
- The river level has varied considerably over the last few years, and incidents of bursting of the banks have increased in frequency and impact. The local government has recently increased tax to raise revenue for a barrier system to prevent future flooding.

The SWF's Head of Infrastructure points out that the legal structure of the investment could be such that the SWF avoids paying any costs of constructing the flood barrier. The Head of Risk has warned against structuring the investment in this way.

The CIO says, "Our risk management process aims to identify and classify the risks of investments as insignificant, moderate, or significant." The CIO further categorizes the major risks of the infrastructure project into three classifications.

Insignificant risks:

- Usage of the bridge being lower than expected
- Default risk

Moderate risks:

- Currency risk
- Interest rate risk

Significant risks:

- Project delay costs
- Maintenance costs being higher than expected

In addition, the CIO notifies Ramil that the SWF is still conducting research to classify any political risk associated with the project.

Question 2.1

State the major risk to the SWF from structuring the infrastructure investment in such a way as suggested by the Head of Infrastructure. **Explain** why this risk factor is significant to the SWF.

Scoring Guide:

2 points for identifying the risk

1 point for the explanation

3 points total

Explanation:

Model Answer

Reputational risk is the major risk the SWF would face from structuring the investment in such a way as to avoid contributing to the taxes that raise revenue for flood barriers. A perception that the SWF is engaging in aggressive tax avoidance in a foreign country where it is making a significant investment could be damaging to the fund's reputation with that country's government and the local community. Damage stemming from reputational risk could be greater than damage from financial risk factors since it could affect the SWF's ability to access deals, impair the valuation of its investments, and, if severe enough, prevent the SWF from meeting its long-term objectives.

Question 2.2

Justify why each risk classified as insignificant is correctly categorized.

Scoring Guide:

3 points for this question

Explanation:

Model Answer

The risk that the bridge usage is lower than expected is an insignificant risk to the SWF since payments are based on availability, not usage. If the bridge is in good operational condition, the government will make the fixed payment under the agreement with the SWF regardless of the actual usage of the bridge.

Default risk on the debt used for the project is an insignificant risk to the SWF since the local government has offered guarantees to the investors in the bonds used to finance the project. Any default on payments to the bondholders would therefore be a matter for the government and the investors in the bonds.

Question 2.3

Recommend a method the SWF can use to hedge each risk classified as moderate.

Scoring Guide:

3 points for this question

Explanation:

Model Answer

The foreign government will make a fixed payment to the SWF in its local currency in the event the bridge is operating satisfactorily after the construction period. The SWF could hedge the risk that this foreign currency weakens by selling the foreign currency forward or by using a currency swap to pay a fixed leg in that currency and receive a regular fixed payment in the SWF's domestic currency.

The interest rate risk associated with the fixed bond payments relates to interest rates falling over the life of the project, making the fixed liability increase in value. To hedge this risk, the SWF could enter a receive-fixed swap with a swap dealer; the swap would profit if interest rates fell, offsetting losses on the underlying project.

Question 2.4

Describe how the risk management team could assess the political risk of the project.

Scoring Guide:

3 points for this question

Explanation:

Model Answer

The political risk of the project is the risk that the government might attempt to change agreements, enter into disputes with the SWF, or even expropriate (ie, take forced ownership of) the project assets. This risk could be assessed by looking at the track record of the government with international investors to establish whether there have been previous disputes or concerning behavior from that government.