

New approach: Regional Risk Premiums

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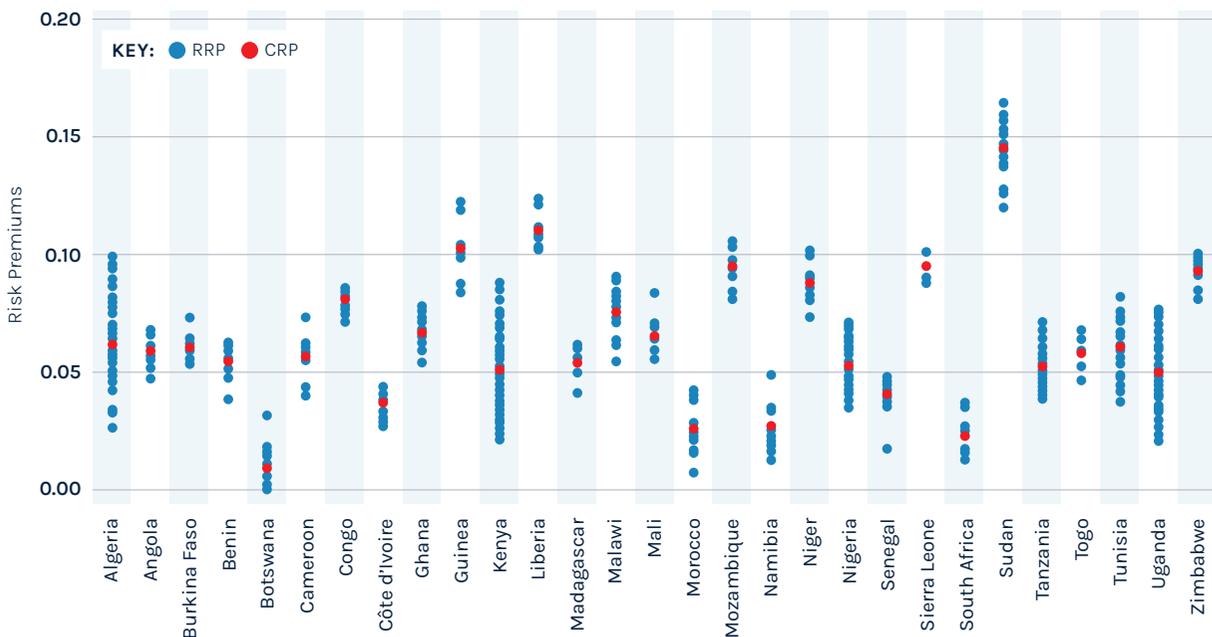
This report advocates for a paradigm shift towards a more precise evaluation of risk premiums, taking into account regional variations within individual countries.

Country-level not enough

Investment decisions have traditionally been largely based on country risk premiums (CRP), particularly in developing countries. However, risk within one country's territory can vary considerably, depending on the specific regional, or even local, context. This **heterogeneity of risk within countries** suggests that the prevalent country-level approach often leads to the overpricing or underpricing of risk in a vast majority of investments, especially in developing countries.

Regional risk premiums - methodology

This report **decomposes** the country risk premium into **regional risk premiums (RRPs)** using regional variation in risk measures. To do so, it compiles a comprehensive array of variables at the sub-national level (over 50, including surveys, administrative sources, satellite imagery, etc.) to categorise risks into four distinct types, using a principal component analysis approach: social, economic, political, and natural. These data are then utilised for the decomposition through a two-step analysis.



First, we estimate the correlations between the four risk types and the CRP. Subsequently, these correlations are used to estimate RRP, drawing upon their regional variation. In the graph below, the 2015-2020 average of RRP for each country is plotted in blue, and the corresponding country risk premium in red.



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The approach highlighted in the report reveals **significant discrepancies in risk within countries**, emphasising the importance of a **geographically granular risk assessment** over a broader country-level analysis. Key examples of this are provided through **two case studies** below.

Case studies emphasise need for granular risk assessment



Conakry Region, Guinea

Despite being a key economic hub, Conakry experienced a paradox in risk assessment from 2015 to 2020. The region underwent significant economic growth, as evidenced by increased night lights (a proxy for economic activity), improvements in the Human Development Index, population growth and enhanced household economic conditions. However, during this period, Guinea's CRP rose, suggesting higher investment costs in Conakry, despite its economic growth. This was attributed to worsening conditions in other regions of the country. In contrast, the RRP for Conakry accurately decreased, reflecting its economic development, while it increased for the rest of the country.



Cross River Region, Nigeria

The Cross River Region in Nigeria faced increased violence and instability from 2015 to 2020, marked by rising incidents of robberies, riots, protests and economic challenges. Despite this, Nigeria's overall positive GDP growth overshadowed the increased risk in Cross River, resulting in a decline in the CRP. This decline was misleading as it did not reflect the actual risk in the region. Conversely, the RRP for Cross River rightly increased, aligning with the region's higher risk level.



A numerical example

To translate concepts into numbers, let us **compare investment scenarios in two different regions**: Kankan, a region in Guinea (average CRP 10%), with Hola, a region in Kenya (average CRP 5%). Assuming a U.S. base interest rate of 3% and an investment of 1M U.S. dollars, the interest payment for a one-year investment in Kenya would be USD 80K, whereas in Guinea it would be USD 130K. However, Kankan is actually richer (33% higher average night lights), safer (50% fewer conflict events), and has a better political system (5% more freedom to vote) compared to Hola in Kenya.

The example illustrates how the use of country-level CRPs can lead to skewed investment decisions, potentially causing misallocation of resources - in this case, **under-investment in economically promising regions** like Kankan and **over-investment in less favourable regions** like Hola.

This new methodology for assessing regional risk premiums is recognised for its significant potential in improving investment decisions and risk assessments at a regional level. Indeed, the RRP for both Kankan and Hola are similar, at around 9%, more accurately reflecting their actual risk profiles and economic conditions.



Regional risk evaluation is crucial for developing economies

This report advocates for a **paradigm shift towards a more precise evaluation of risk premiums that takes into account regional variations within countries**. This shift is deemed especially crucial for developing economies, where accurately allocating resources and investments based on regional risk profiles can have substantial and far-reaching consequences.

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