

Country Risk-The new risk in  
the block

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With the recent debt troubles of Dubai, Greece, and other sovereigns, country risk has become an important and immediate concern. What happens when a country defaults, and is there any way to predict if a default is coming? Country risk entails the possibility that a sovereign debtor will be unable to pay principal or interest because of unexpected events in the debtor's country. It is defined more broadly as the risks in *all* types of foreign investments, equity or debt, arising from a country's social, political, or economic conditions.

### **Sovereign default**

Sovereign default occurs when a country either possesses insufficient reserves or is unwilling to use its reserves to service its interest or short-maturity claims. Default may be accelerated by creditors or debtors. If a debtor is perceived near default, creditors have an incentive to avoid rolling over debt and a "rush to the exits" can precipitate a default. A sovereign may have an incentive to default if it lacks the political will to effect unpopular policies needed to service its obligations, or if it perceives that a restructuring will offer lenient terms without long-term adverse consequences.

### **Sovereign debt restructuring**

In a sovereign debt restructuring process, the IMF takes the lead role, supplying new capital with conditions. By contrast, *official* (sovereign-to-sovereign) debt is usually restructured through the Paris Club<sup>1</sup> where debt relief involves a case-by case assessment of debtor requirements. Domestic debt is usually restructured internally, since a government has control over local law and local currency. Creditor priority is the primary issue in sovereign debt restructuring because these restructurings lack a legal framework and a variety of debt securities can be involved. The principle of *pari passu*—the equal treatment of all creditors—is modified for sovereign restructurings. Generally, the debts of international financial institutions (e.g., the IMF) have preferred creditor status and are outside the restructuring process. External bondholders and certain trade credits have preferred status over sovereign and domestic creditors.

After Argentina's 2003 default, IMF staff proposed a statutory bankruptcy procedure for sovereigns (the Sovereign Debt Restructuring Mechanism) to address priority issues and the problem of holdout creditors. The Mechanism was never adopted, however, because private creditors favored addressing creditor priority through collective action clauses built into

the debt contract itself. Majority action clauses, for instance, bind all bondholders to a negotiated settlement after acceptance by a defined majority, and most new emerging market issues now contain this clause.

### **Treatment of private debt**

Some priority issues remain unresolved, like the appropriate priority for *individual* investors/creditors, an issue in Argentina's ongoing restructuring. In most sovereign restructurings, creditors are provided with a menu of options, including adjustments in bond maturity, coupon, principal and collateral, or an exchange of new bonds, with different terms, for old debt.

Other private debt defaults are treated variously. Syndicated loans are renegotiated in a coordinated work-out with bank creditors. Private (bond) debt becomes part of bankruptcy proceedings in the debtor's country, where creditor priority depends on the legal framework prevailing in that country.

### **Country risk assessment**

Methods used to assess country risk vary widely. They involve a range of risks (credit, default forecasts, risk capital allocations) and a degree of subjectivity in the choice of risk categories, their weightings, and qualitative assessment. They take the form of country rankings, numerics (credit rating, risk index), or default estimates. For instance, *Euromoney* ranks countries according to ability and willingness to service debt and uses both quantitative data and expert surveys. Other entities provide risk ratings for various purposes. The Economist Intelligence Unit ([www.eiu.com](http://www.eiu.com)) provides country risk ratings based on an expert survey of a set of qualitative and quantitative questions. Many firms, like Business Environment Risk Intelligence ([www.beri.com](http://www.beri.com)) and Political Risk Services ([www.prsgroup.com](http://www.prsgroup.com)), sell country risk assessments to corporate clients. Export credit agencies calculate ratings to assign premium rates for exporters' risk insurance, and the relative size of the premium is used to assess country risk. S&P, Fitch, and Moody's issue ratings for specific debt issues, both sovereign and corporate, and local and foreign currency debt. Once traded, credit default swap prices, and the bond's yield spread over other creditors, can provide ongoing risk assessment. Despite the early warning systems available, the recent financial crisis shows that even stable, seemingly safe countries like Iceland can very suddenly appear to be dangerous territory. After all, Moody's lowered Iceland's

sovereign debt rating to A1 from AA1 a day *after* the country's credit default swaps were priced at an exceptional \$1.5 million per \$10 million.

### **Conclusion**

Keeping current on a country's risk profile, and knowing the priority accorded to a particular investment, can go some way in ameliorating country risk, but ultimately, the acceptance of country risk is the price of acquiring higher returns through international diversification.

### **REFERENCES**

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