Contents

› Definition of country risk and sovereign risk
› Assessment of country risk
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› Implementation
Country risk: development of a crisis

- Strong increase of private and/or public debt drives domestic demand and GDP
- High import demand and a loss of competitiveness due to rising wages (real appreciation of the currency) lead to a current account deficit
- Banking sector and/or sovereign accumulate external debt
- Maturity structure of external debt shortens

Crisis trigger: Sudden shift in risk aversion, terms-of-trade shock, political events

- Loss of confidence (capital flight: no market funding available, drop in bond prices, run on bank deposits)
- Strong devaluation, deep recession, strong increase in private sector insolvencies, bank insolvencies, sovereign default, transfer restrictions

Systemic financial crisis due to a lack of foreign currency liquidity
**Definition of country risk vs. sovereign risk**

Counterparty risk

- Sovereign
- Banks
- Corporates
- Individuals
- ...

Country (transfer) risk

Add-on on counterparty risk for cross-border/foreign exchange exposures

Total Counterparty risk

Counterparty risk in foreign currency and cross-border

- Sovereign risk and country risk measure different risks, but are strongly interrelated
- Different rating systems due to different nature of risk, but overlapping indicators
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Country risk analysis via rating systems

- Expert system due to lack of data points
- Keep it short and simple: Transparency for analysts and users
- Quantitative indicators:
  Consistent evaluation method for all countries (fixed scales)
- Qualitative aspects:
  Quantification in relation to other countries (peer group comparison)
- Overruling of model result in special cases not captured by the model
Country risk and time horizon

Risk is rising with increasing maturity

**short-term:** liquidity indicators

**medium-term:** economic policy

**long-term:** structure of economy

dominant aspects
Time frame: 1 year

Risk assessment

- Liquidity situation
- Business cycle
- Foreign debt
- Structure of economy
- Management of economy
- Political Stability
- Credit-worthiness

Quantitative
Qualitative

Credit-worthiness
Foreign exchange liquidity situation of high relevance

Example 1: Liquidity deficit

- Capital flight
- Amortization on m/l term debt
- Shortterm debt
- Current account deficit

Example 2: Liquidity surplus

- Capital outflows possible
- Net FDI outflow
- Capital flight
- Amortization on m/l term debt
- Shortterm debt
- Forex reserves
- Current account surplus
# Quantitative indicators

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| Foreign debt                      | External debt                        |
## Qualitative indicators

| Structure of economy | Diversification of exports and total economy  
|                      | Competition in the domestic market  
|                      | Sector risks (e.g. real estate bubbles)  
|                      | Stability of the banking sector  
| Management of economy | Economic Policy, Role of the government in the economy  
|                      | Corruption, Protection of Property rights, Investment climate  
|                      | External debt and liquidity management  
| Political Stability  | Domestic stability (economic, ethnic or religious conflicts)  
|                      | External security (war or threat of war)  
| Creditworthiness     | Rating agencies  
|                      | Bond spreads |
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› Definition of country risk and sovereign risk
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Characteristics of sovereign risk

› Counter party risk for sovereign entities
› Focus of financial (fiscal) situation of the sovereign
› and it’s ability to get financing from international capital markets

› Willingness to pay a special sovereign risk (political risk)
› lack of international insolvency law for sovereigns; ability to change national law
Sovereign risk indicators

- Business cycle
- Structure of economy
- Management of economy
- Political Stability

Risk assessment

- Budgetary situation
- Revenue & expenditure structure
- Government debt

Financing situation

Non-Budget / country risk

Industrial countries und major emerging markets
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Implementation

Rating (Probability of default)

Loss given default (recovery)

Exposure at default

Minimum capital requirement

Expected loss

Risk management

Medium- and long-term assessment

Margins

Provisioning

Transaction types

Limits

Transaction types

Minimum capital requirement

Risk management

Expected loss

Loss given default (recovery)

Rating (Probability of default)

Exposure at default

Medium- and long-term assessment
Thank you!