Working Paper (04/14/21):

The Long Reach of Country Risk: Event Risk Crisis and Non-Bank Financial Institutions (NBFIs)

Executive Summary –

Lending banks are often thought be the major holders of international exposure and therefore country risk. Non-bank financial institutions, such as hedge funds, pension funds, private equity funds and others, often incur and accumulate significant country risk as well.

Of timely importance, the recent failure in March 2021 of family office **Archegos** (see "Case Examples" section below) highlights the risk leveraged exposure presents to any firm's ongoing financial solvency, and has implications for understanding country risk for NBFI's.

While Archegos did not fail due expressly to foreign asset exposure (an example of country risk), it's financed exposure to foreign securities can be construed as risk intensive behavior, as "booked" country risk, and as an example of "whistling past the graveyard" in this respect.

Moreover, the leveraged concentration risk which Archegos booked entailed another consequential one – event risk. Country risk – as manifested through sudden geopolitical developments, sharp changes in national policies, and institutional fragility – is an exemplar of event risk

Main Body –

Introduction: What is "country risk"? And, what do we mean by "non-bank"?...

A country's sovereignty - its sovereign authority - engenders the ultimate legal and political recourse in a specific sovereign jurisdiction. Sovereign risk is the default risk a sovereign obligor represents on a sovereign debt. To illustrate, the major rating agencies such as Standard and Poor's and Moody's assign sovereign credit ratings on the specific debt issuance of sovereign issuers**.**

Country risk is a broader concept, including not only sovereign risk – the risk of sovereign default on a sovereign debt – but also the following manifestations:

- ✓ Capital control risk – the inability to transfer capital from the domicile country
- ✓ Currency inconvertibility risk – the inability to convert local currency into foreign currency
- ✓ Expropriation risk – sovereign seizure of local assets
- ✓ Performance risk – in the local environment, such as counterparty risk, operational risk

Country risk, in its different examples, can present a number of ways in which a bank or any financial institution can incur cross border risk exposure and loss.

How do Non-Bank Financial Institutions (NBFIs) incur country risk?

In the midst of the Global Financial Crisis, the IMF effectively "rebooted" consideration of sovereign risk and country risk, highlighting broad ramifications and reach –

"The traditional definition of sovereign risk (broadly, the probability that a country may not pay its debts) has been shown to be too narrow by the global financial crisis. Developments since mid-2008 have exposed very complex interactions between fiscal balances, public and private sector debt, and the financial sector." (IMF Press Release No. 11/91; March 18, 2011)

Non-bank financial institutions (NBFIs) can include private equity firms, investment asset managers, pension funds, sovereign wealth funds and family offices and can incur country risk exposure, as the IMF implied.

In their variety, NBFIs can book country risk exposure through –

- ✓ Concentration/obligor – exposure through holding a foreign country asset issued by the sovereign, a public entity, a local authority or a business
- ✓ Collateral – security held in the form of a foreign country asset
- ✓ Synthetic – derivative exposure based on a foreign country asset
- ✓ Counterparty – facing performance risk to a foreign based counterparty

Case studies to consider –

Long-term Capital Management

Context:

In 1998, LTCM is a hitherto highly successful, highly leveraged hedge fund @ 25-30x capital. It specializes in "convergence" trades.

Country Risk Catalysts:

The 1997-98 EM Asia Crisis and the Russian GKO-RUR Crisis in 1998 confound LTCM convergence bets, precipitating large losses.

Consequence:

In less than half a year, LTCM loses USD 4.6 bln, roughly its equity base. In autumn 1998, 16 financial institutions inject USD 3.6 bln, recapitalizing the fund and effectively wiping out equity holders.

Everest Capital

Context:

In January 2015, the Everest Capital global macro fund has USD 1.0 bln under management. It is also running a massive CHF short exposure position.

Country Risk Catalysts:

That same month, the Swiss National Bank (SNB) does the unexpected and opts without warning to end a three-year old policy of maintaining a EUR 1.20/CHF floor. The Swiss franc appreciates sharply.

Consequence:

As Bloomberg News reports on the episode, "…the hedge fund manager (i.e., the fund), who survived at least five emerging market debt crises, is closing his largest hedge fund after losing virtually all its money last week when the Swiss National Bank unexpectedly…"

Archegos

Context:

In March 2021, Bill Hwang, investor and managing principal of family office Archegos, maintained several highly leveraged equity total return swaps with different prime brokerage units (PBs). Those PBs included Goldman Sachs, Morgan Stanley, Credit Suisse, Nomura, Deutsche Bank and UBS.

Country Risk Catalysts:

While not a country risk event, the situation is analogous and noteworthy. Archegos maintained a long exposure, through its swap exposure, to Viacom-CBS. That exposure, hitherto profitable, shifted suddenly to a loss when Viacom announced in March its intention to issue more shares. The market reacted negatively to the announcement, and the plunging Viacom share price prompted margin calls which Archegos could not meet. Of note, Archegos maintained other large concentration positions in Discovery, Inc., Chinese New York-listed tutoring company GSX Techedu, Tencent Music Entertainment Group, Baidu, Inc., and IQIYI, Inc.

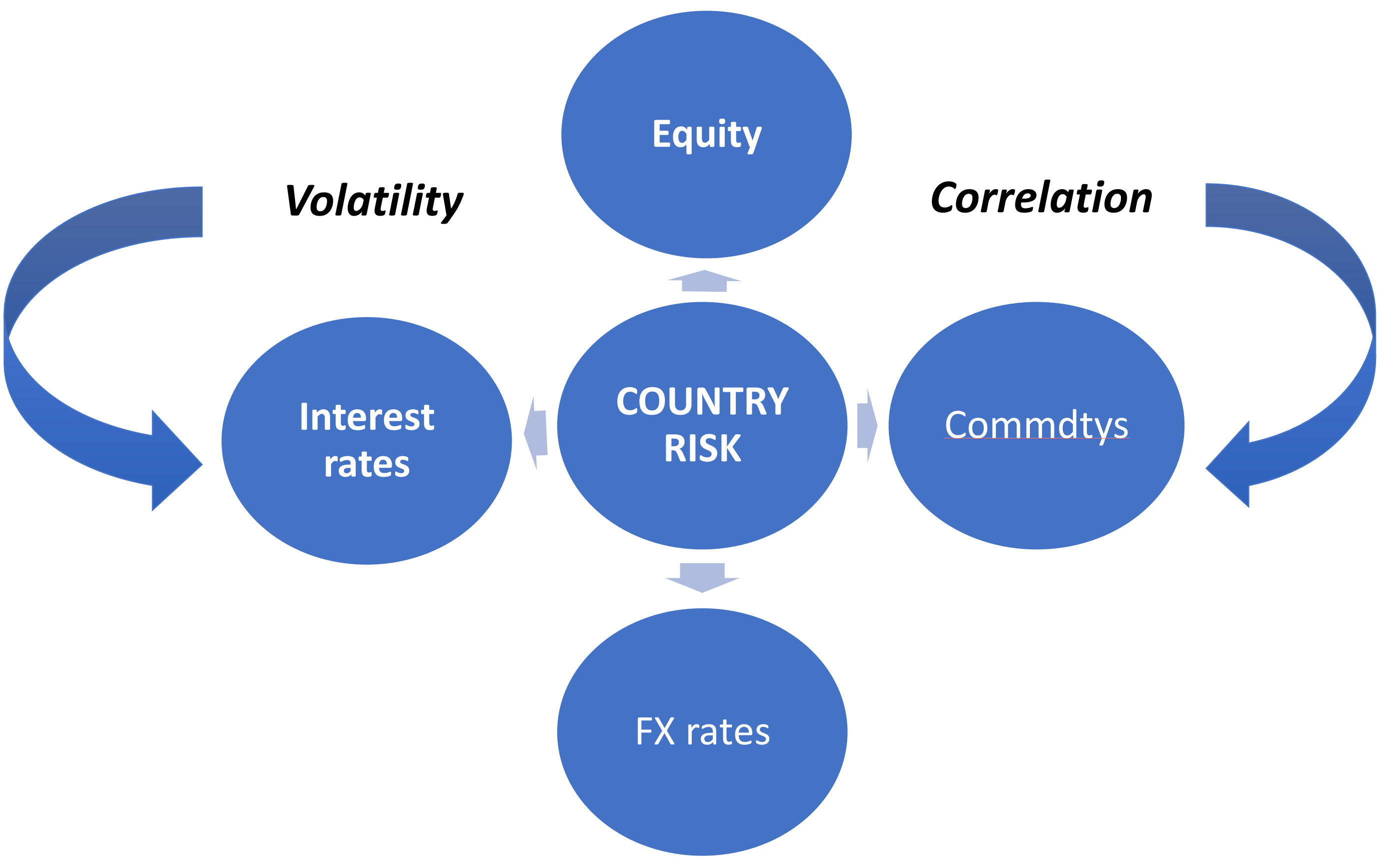
Consequence:

Archegos' failure to meet margin calls entailed forced liquidation of stock positions. While certain prime brokers were able to exit exposure relatively unscathed, Nomura and Credit Suisse incurred substantial losses. According to analysts at JP Morgan Chase, estimated losses among prime brokers could range between USD 5.0 bln to USD 10.0 bln from the Archegos collapse.

Country Risk – in everything, and everywhere…

The reality to bear in mind: Event risk can topple poorly risk managed institutions, and ***country risk is a fertile source of event risk***. Realized event risk can jostle risk factors, correlations, price volatility and ultimately asset value, directly effecting portfolio and balance sheet health, if not viability.

Country Risk – influencing all factors…



Summary –

For NBFIs, it is important to be a pro-active risk manager and to manage leveraged exposure and concentration risk. This is one of the few practical ways to protect an institution from a sharp, unanticipated event risk episode. To do so, again, requires the organization to be pro-active and to ensure effective communication among Risk, Business, and Executive Leadership.

Given country risk as a fertile source of event risk, it is important to bear in mind the following:

- ✓ Country Risk is broader than the narrowly defined risk of sovereign default
- ✓ NBFI activities and exposures can incur country risk
- ✓ For banks and NBFIs, country risk is protean – across risk factors and geographies
- ✓ Failure to discount effectively country risk can lead to firm demise

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