Overview of Country Risk Transfer Instruments

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In conjunction with the Committee on the Global Financial System work group project on foreign direct investment in emerging market financial sectors, staff of the Federal Reserve reviewed the development and characteristics of markets for risk transfer instruments and their use by banks to manage risks associated with their emerging markets exposures. The review has focused, in particular, on credit derivatives, non-deliverable forwards ("NDFs"), and political risk insurance ("PRI") and included interviews with U.S. commercial banks, investment banks, and insurance companies active in these markets[1], and follow-up research and discussions.[2]

This analysis suggested the overall conclusion that, while risk transfer instruments provide a useful additional set of tools, they appeared to be of relatively limited influence in direct investment decisions and overall balance sheet management (as compared to active market-making activities). Participants emphasized that accurate identification of risks that banks can accept, proper pricing of transactions to reflect risk, and avoidance of excessive concentrations are the main approaches to limiting risk. Strategies to hedge or transfer risks – including through risk transfer instruments – were secondary, in part because they are costly and imperfect forms of protection. Generally, participants argued that it is not possible to transfer all risks or provide a substitute for the careful examination of the fundamental investment characteristics of particular countries.

These products are effectively used to transfer discrete categories of risk. While difficulties have been encountered in certain crisis situations, such as Argentina, improvements in risk transfer instruments have been made in response to these situations – for example, the development of fallback pricing mechanisms for NDFs when there are local market disruptions, and the tightening of credit event definitions used in emerging market credit derivatives. Finally, participants believe that risk transfer products provided important completeness to many asset markets, enhancing liquidity and reducing pricing distortions.

Discussions with market participants suggested distinctions between different instruments. Participants expressed the greatest interest in credit derivatives, which have grown rapidly in recent years, citing the flexibility of these instruments and improvements in standard contractual language. NDFs were actively traded, but saw relatively limited use as a balance sheet risk management tool, with greater use hampered by the limited scope of risks transferred by such instruments and the lack of correlation between broader "country risk" and foreign exchange risk, among other issues. Discussants attributed the limited use of PRI to high prices for policies and gaps in coverage, with product limitations highlighted in recent emerging market

[1] Unless otherwise noted, interview "participants" include both users and suppliers/market-makers of products – often the same institutions in the case of credit derivatives and NDFs.

[2] The views expressed herein are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System. The author gratefully acknowledges the assistance of Damon Palmer in the development of this note.

crises, where investors suffered losses reflecting, in some cases, ambiguities in contract language and gaps in coverage not anticipated by investors.

Beyond these general issues, participants noted several specific issues that, to varying degrees, restricted the usefulness of different risk transfer instruments as a means to manage risks on emerging market exposures. Among these were the limited scope of risks covered by each product; uncertainties surrounding the difficulty in defining triggering events; and relatively limited market depth and liquidity.

A factor limiting the ability of these products to comprehensively hedge country risk is the restricted scope of risks transferred by each instrument and the consequent inability of any given instrument to hedge all important potential sources of loss. Financial institutions have increasingly come to recognize that country risk – particularly for direct investments – involves a very wide set of potential risks, including traditional credit and market risks, diverse forms of expropriation risk, convertibility risks, and potential losses from changes in the broader legal and regulatory environment of host countries, among others. Credit derivatives provide the broadest coverage, enabling institutions to transfer credit risk – ranging from outright default to restructuring risks – on underlying "reference" entities or obligations. NDFs enable institutions to hedge local currency exposures in emerging market countries with existing or potential capital controls – but do not protect institutions against other market risks, credit risks, or expropriation risks. Finally, PRI offers the ability to transfer narrowly-defined risks from imposition of exchange controls, expropriation or political violence – but enumerates only a limited number of risks and provides no protection against market or credit risks. While the different instruments are to a significant degree complementary, institutions are generally unable to construct effective "composite" hedges from different instruments.

A second broad challenge inherent in these contractual risk transfer instruments is the difficulty in defining the events that trigger payment under the contracts and consequent uncertainty or delay in enforcement of contractual rights of risk transfer. Credit derivatives present such difficulties given the inherent difficulty of enumerating all potential sources of credit-related losses as well as uncertainties associated with sovereign debt restructurings (as shown in the Argentine case), although interview participants were generally positive regarding the refinements to the ISDA restructuring definition in 2003. PRI faces similar challenges, given difficulties in anticipating and describing all possible manifestations of country risk (particularly in the case of "creeping" expropriation) without creating overly specific and unwieldy contracts. Such ambiguity can lead to subjective determination of event occurrence, fostering investor concerns over insurer willingness to pay, as well as insurer frustration that investors do not understand the coverage. Participants noted few problems with definitions *per se* in NDF contracts, because payment on NDFs is not contingent on a particular event occurring. However, NDFs have presented the challenge of finding alternative viable price sources should local markets close or exchange rates used to price NDFs otherwise become disrupted.

A further factor restricting the applicability of risk transfer instruments is the generally limited market depth and liquidity of the associated product markets – generally closely related to and affected by the same factors as the liquidity of associated cash markets. Liquid emerging market credit derivatives are generally available for a relatively limited range of sovereign credits and the most creditworthy emerging market corporates – with liquidity in given names often varying dramatically with changing risk perceptions. Similarly, participants noted that PRI was not generally available for high-risk countries at economically attractive prices – with insurers generally willing to offer PRI only for low- to medium-risk countries, limiting the market for coverage of relevant risks. The lack of market depth appeared to present a lesser issue for

NDFs, since fairly liquid offshore markets have developed for NDFs in currencies of certain emerging market countries.

In terms of the outlook, discussants generally anticipated further development and growth in the use of risk transfer instruments but did not expect such instruments to be decisive to emerging market financial sector FDI flows. Growth in emerging market credit derivatives was viewed as likely to parallel that of the broader credit derivatives market, and NDFs were expected to continue in the context of ongoing convertibility restrictions for currencies of countries with significant foreign investor involvement. Despite its limitations, PRI will continue to support emerging market investment; recent experience may lead to a refinement of contract wording and improved investor understandings, although uncertainty and ambiguity are not likely to fully disappear, due to the inherently subjective nature of determining policy triggers.

While participants regarded institutional reforms in product markets to be useful – citing improvements in current generations of contract language in credit derivatives and NDFs as contributing to market growth – an overall conclusion of participants was that deeper and more liquid product markets would likely depend most importantly on improved country fundamentals. Greater product market depth and institutional use would thus depend critically on the development of deeper local financial markets, improvements and stability in host country regulatory and legal environments, and improvements in the creditworthiness of local counterparties and the local business environment.

For more product detail, please see the following notes on the BIS website:

Hamdani, K., E. Liebers and G. Zanjani, “An Overview of Political Risk Insurance”, May 2005.

Lipscomb, L., “An Overview of Non-Deliverable Foreign Exchange Forward Markets”, May 2005.

Dages, B. G., D. Palmer, and S. Turney, “An Overview of the Emerging Market Credit Derivatives Market”, May 2005.