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A COMPARISON OF TWO COUNTRY RISK ASSESSMENT APPROACHES

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A COMPARISON OF TWO COUNTRY RISK ASSESSMENT APPROACHES

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Abstract of a D.P.S. Dissertation

Robert S. Mankin

A Comparison of Two Country Risk
Assessment Approaches

This study was undertaken with the purpose of advancing the field of "country risk" assessment and assisting United States commercial banks in their selection of the appropriate approach to use in such assessments. To accomplish this objective the writer compared two approaches--the "structured qualitative" and the "market-oriented."

The writer tested the basic hypothesis that if countries are ranked by each of the approaches, the rankings resulting from one approach will not be strongly positively correlated with those resulting from the other approach. One-year assessment horizons were used. The writer chose two models--one to represent each of the approaches studied. A set of twenty countries that were the major borrowers on the Euromarket between 1975 and 1979 were ranked by each method.

There was no indication of strong positive correlation in any of the cases studied. This led to the conclusion that given the lack of solid theoretical foundation for the qualitative method combined with little empirical evidence for its validity, the method should be rejected. The market-oriented approach does have roots in financial theory, and it should be the method that

banks employ.

The writer points out that further research in the field is needed in order to accelerate the rate of progress to meet the growing needs for rapidly improving country risk assessments.

ACKNOWLEDGMENTS

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Robert Mankin

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CHAPTER I

INTRODUCTION

FORMULATION OF THE PROBLEM

The United States banking system has become highly dependent upon the foreign lending activities of its major banks. This dependence has grown concomitant with the changing realities of the world. In past years, United States banks were primarily domestically oriented institutions, whose risk management processes were carried out within a framework of United States political, social and economic environmental factors. Today, United States bankers and bank regulators believe that new ways to manage risk are required in order to deal with loans to foreign entities. These entities operate under sovereigns who, because of social, political and economic conditions in their countries, might prevent loans from being repaid as the bankers had expected. This study is concerned with one aspect of risk management, risk assessment. This section poses the general problem of "country risk" assessment and its associated sub-problems. It articulates the specific purpose of the research and the reason for its importance. The basic hypothesis and set of assumptions are made explicit, as are the questions to be answered by, and the limitations of, the study.

Definition of Terms

The following definitions will be used for the purposes of this study.

Country risk is the exposure to losses on loans to a foreign obligor arising uniquely from the obligor's government's response to the economic, political and social conditions of the obligor's nation. The loss is a lower return to the lender than he had anticipated in the original arrangement. Nicholas Sargen has noted that commercial banks encounter two types of risk unique to international lending: (1) sovereign risk; and (2) transfer risk. The former is the risk attributable to either the refusal or inability of a national government to repay foreign loans or to its seizure of bank assets without adequate compensation. The latter is the risk that foreign borrowers will encounter difficulties because of action(s) taken by their government.[1]

The term commercial banks is used to describe profit-seeking financial institutions that are authorized by either the state or national government to take demand deposits. "Only commercial banks hold demand deposits."[2]

Eurobonds are bonds sold by international groups of banks in several markets simultaneously on behalf of international

[1]Nicholas Sargen, "Economic Indicators and Country Risk Assessment," Economic Review: Banking In The World Economy, (San Francisco: Federal Reserve Bank of San Francisco, Fall, 1977), p. 20.

[2]Charles R. Whittlessey, Arthur M. Friedman, Edward S. Herman, Money and Banking Analysis and Policy (New York: The MacMillan Company, 1966), p. 76.

borrowers. Foreign bonds "...are issued for a nonresident borrower in the domestic capital market of another country under the laws and regulations of the country in which they are issued."[3] Eurocredits (Euroloans) are medium-term international credits in currencies which are not necessarily those of the borrower. These credits are granted by bank syndicates. Eurocurrency is currency deposited with a bank located outside of the country that issues the currency as legal tender.

Statement of the Problem

The general problem is to provide a uniform approach to ranking countries according to the likelihood that a country's government, because of some combination of social, political and economic factors, will interfere with payments of interest and principal owed to foreign commercial banks. (The commercial banks of interest in this study are those of the United States of America.) Such a ranking system will be called "country risk assessment." Country risk assessment has become very important to banks, regulators and academics in the United States in the past decade. This is because of the magnitude of the loans to foreign entities, their concentration among a relatively few banks in the United States banking system and the nature of the borrowers' political, social and economic environments.

The magnitude of foreign loans by banks grew rapidly during the decade of the nineteen seventies. The Federal Reserve Bank

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[3]M.S. Mendelsohn, Money On The Move - The Modern International Capital Market (New York: McGraw-Hill Book Company, 1980), p. 273, 1980.

has estimated that the gross value (interbank deposits are included) of these claims, held by international banks (United States and foreign), increased from $204 billion at the end of 1972 to $903 billion by the end of 1978. After interbank deposits were netted out, the year-end 1978 figure was $540 billion; it was $121 billion at the start of 1973. There was an average annual rate of growth of nearly 29 per cent.[4] The volume of Eurocredits, Eurobonds and foreign bonds grew from less than $10-billion in 1960 to in excess of $60 billion by 1977.[5]

United States banks have been major participants in lending to foreigners. Using Walter's figures for 1978, $236 billion of the total $903 billion gross value of foreign claims were held by United States banks.[6] This figure includes both money lent directly from the United States (onshore), as well as money lent by the branches of United States banks outside of the United States (offshore). Onshore, United States banks' foreign claims experienced a 30 per cent compound annual growth rate between 1972 and 1977, the value of the claims moving from $21 billion to $92 billion.[7] In November 1980 the foreign claims of United

[4]Figures provided by Ingo Walter in an interview at New York University on 12/12/80 and in a paper, "International Capital Allocation - Country Risk, Portfolio Decisions and Regulation in International Banking" presented in draft form at the conference Internationalization of Financial Markets and National Economic Policy at the Graduate School of Business Administration, New York University in New York City, on 10-11 April, 1980, p. 10.

[5]M.S. Mendelsohn, op. cit., p. 4.

[6]Walter, op. cit., pp. 2-3.

[7]Janice M. Westerfield, "A Primer On The Risks Of International Lending and How To Evaluate Them," Business Review, (Philadelphia: The Federal Reserve Bank of Philadelphia, July-August, 1979), p. 20.

States banks exceeded $336 billion and, of this total, cross-border and non-local currency claims approximated $266 billion.[8]

The magnitude of the United States banks' foreign claims suggests their dependence on these claims. Another indicator of this dependence is that a relatively few, huge United States banks hold the major share of these claims. In 1977 Stephen Goodman pointed out that, "In the largest United States banks the share of developing country credits in the total portfolio now ranges as high as 30% and is still growing." He added that in 1976, 12 United States banks accounted for half of the United States banking system's international loans.[9] Korth noted in the same year that if one were to use foreign deposits as a share of total deposits (a seemingly reasonable approximation in that foreign loans are largely funded abroad), the major New York and Chicago banks would turn out to be the most heavily committed. "A total of 25 United States banks have foreign deposits (and presumably loans) of at least $1 billion each."[10]

Overseas loans account for a large share of the earnings of the major United States banks. Foreign loans account for well

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[8] "Country Exposure Lending Survey," Joint News Release, (Washington, D.C., Comptroller of the Currency and the Federal Deposit Insurance Corporation, November 24, 1980).

[9] Stephen Goodman, "How the Big U.S. Banks Really Evaluate Sovereign Risks," Euromoney, (London: Euromoney Publications Ltd., February, 1977), p. 105.

[10] Christopher M. Korth, "Developing a Country Risk Analysis System," The Journal of Commercial Bank Lending, (Philadelphia: Robert Morris Associates, December, 1979), p. 56.

over 50% of their earnings each year.[11] Hanley performed a study of the foreign earnings of thirteen major bank holding companies between 1970 and 1976. He found that their foreign earnings (not totally attributable to loans) rose by about $700 million; domestic earnings rose by less than $40 million. In 1976, more than half of the total earnings for each of six of these holding companies came from their foreign operations.[12] David Sias, the head of Bankers Trust's international department, has put his concern regarding overseas loans quite succinctly, as cited in Euromoney. "Given the margins we are dealing with today, one bad call wipes out 15 years of profits."[13]

The foreign loans of United States commercial banks blanket the globe. However, many of them are to entities in less developed countries; for example, Turkey, Brazil, South Korea, and Mexico, countries whose problems are frequently highlighted in the press. Examples of press reports are the following:

> The Turkish officials wander the world trying to reschedule their already rescheduled debt, bankers are wondering why the Turks are not fully using what is already available to them.[14]
>
> The major problem is to ease the burden of the external debt. The funded external debt is now close to $5 billion, although hard figures

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[11]"Meet the New Breed of Banker: The Political Risk Expert," Euromoney, (London: Euromoney Publications Ltd., July 1980), p. 9.

[12]Mendelsohn, op. cit., p. 7.

[13]"Meet the New Breed of Banker: The Political Risk Expert," op. cit., p. 10.

[14]"Turkey's Debts," The Economist, (London: The Economist Newspaper Ltd., September 13, 1980), p. 98.

> are difficult to find because World Bank estimates are available with difficulty and delay and because of uncertainty about the extent to which defense acquisitions bought on credit are included in the published debt.[15]
>
> As if the Iranian crisis weren't enough to do it, there were the new cold war fears brought on by the events in Afghanistan and the growing nervousness about the security of the whole Persian Gulf.[16]

In an October 1980 Wall Street Journal article, it was noted that:

> Sudan, a Northeast African nation of critical importance to the United States, because of its proximity to the Middle East, has defaulted on its foreign-bank debt.
>
> Most of the banks haven't received a penny since the end of 1978.
>
> \- - -
>
> Of the $600 million in debt as of Dec. 31, 1979, about $100 million was overdue interest, and the interest due will virtually double this year.[17]

In 1980 Federal Reserve Board Governor Henry C. Wallich noted that the dollar value of United States' commercial bank loans to less developed countries was growing rapidly. According to Wallich, these loans grew by 23% a year on average between 1975 and 1979, approximately a threefold growth in five years.[18]

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[15]"Peru Needs Truth More Than Sympathy," Euromoney, (London: Euromoney Publications Ltd., December 1977), p. 73.

[16]"Rating Country Risk," Institutional Investor, (New York: Institutional Investor, Inc., March 1980), p. 57.

[17]Laura Wallace, "Sudan Refinance Hangs in the Balance," The Wall Street Journal, (New York: Dow Jones, October 27, 1980), p. 33.

[18]"How Much More Can The System Take," Forbes, (New York: Forbes Inc., June 23, 1980).

He further noted that this growth exceeded the rate of overall credit expansion that could be handled by a banking system that was not in the midst of a galloping inflation (as he believed the United States system was). He questioned the ability of the banking system to continue at such a pace. John O. Wilson wrote that there were various estimates that suggested that lending to less developed countries had grown from $45 billion at the end of 1976 to $75 billion by the end of 1977.[19] Nagy noted that the world's commercial banks increased their loans to the non-oil exporting, less developed countries by $77 billion between 1970 and 1977.[20] Caldwell and Villamil compiled a table estimating United States bank claims on a number of developing countries (including oil exporters) from 1975 to September of 1978.[21] Table I, on the following page summarizes their findings.

While estimates vary and international data tend to be less than timely and somewhat unreliable, there is no doubt that huge sums have been, and continue to be, lent to countries at earlier stages of economic development than those in the industrialized West.

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[19]John O. Wilson, "Measuring Country of Risk In A Global Context," Business Economics, (Cleveland: The National Association of Business Economics, January, 1979), p. 23.

[20]Pancras J. Nagy, Country Risk: How to Assess, Quantify and Monitor It, (London: Euromoney Publications Ltd., 1979), p. 13.

[21]J. Alexander Caldwell and J. Antonio Villamil, "U.S. Lenders are Learning to Discriminate," Euromoney, (London: Euromoney Publications Ltd., April, 1979), p. 125.

TABLE I

THE RISE IN QUANTITY

US BANK CLAIMS ON DEVELOPING COUNTRIES ($ billion)

	Year-end			Month-end 1978[1]		
	1975	1976	1977	Mar.	June[1]	Sept.
Total	45.2	n.a.	n.a.	n.a.	73.0	75.2
Non-OPEC	38.2	50.5	55.3	55.8	56.3	57.3
Latin America	27.3	36.7	39.0	39.3	39.9	40.9
Argentina	2.1	2.3	3.3	3.5	3.8	3.6
Brazil	9.2	13.9	14.3	14.7	15.3	16.7
Chile	.6	.8	1.1	1.3	1.5	1.5
Colombia	1.3	1.3	1.4	1.3	1.5	1.5
Mexico	9.9	12.8	13.2	12.8	12.9	13.0
Peru	1.5	1.9	2.0	1.8	1.9	1.8
Other	2.7	3.7	3.7	3.8	3.0	2.8
Asia	8.5	10.2	12.4	12.4	12.5	12.2
India	.2	.2	.3	.3	.3	.3
Korea	2.6	3.2	4.0	3.7	4.1	3.8
Philippines	1.8	2.3	2.5	2.7	2.9	3.0
Thailand	.8	.8	1.2	1.3	1.3	1.3
Other	1.4	1.1	2.1	2.3	2.1	2.2
Middle East & Africa	2.3	2.4	3.9	4.1	4.0	4.2
Turkey	.6	1.0	1.5	1.5	1.5	1.6
Egypt	.4	.3	.3	.3	.4	.4
Other	1.4	1.1	2.1	2.3	2.1	2.2
OPEC	7.1	n.a.	n.a.	n.a.	16.7	17.9
Ecuador	.4	.7	1.2	1.4	1.5	1.5
Venezuela	2.5	4.4	6.1	6.3	6.8	7.4
Indonesia	1.6	2.2	2.3	2.2	2.1	2.0
Other Africa	1.0	1.5	1.9	2.0	2.1	2.3
Algeria					1.5	1.5
Gabon					.2	.2
Libya					.1	.1
Nigeria					.1	.4
Other Asia	1.6[2]	n.a.	n.a.	n.a.	4.2	4.7
Iran					2.2	2.3
Iraq					.1	.1
Kuwait					.5	.5
Qatar					.1	.1
Saudi Arabia					.6	.7
UAE					.7	1.0

[1] Series change.
[2] Includes Bahrein and Oman.