GUARDING AGAINST DEFAULT

GARY WALKER OF WRAGGE & CO ASSESSES THE USE OF CREDIT DERIVATIVES AS PROTECTION AGAINST SOVEREIGN DEFAULT UNDER EMERGING MARKET EXPORT CREDIT CONTRACTS.

Exporters to Latin American, African, Eastern European and other developing markets have traditionally looked to credit agencies, private insurance companies and the trade finance markets to provide protection against sovereign default and related risks. The credit derivative (CD) market (of which sovereign risk products are a sub-class) has recently emerged as a viable alternative source of protection. Under a sovereign risk credit derivative, a bank 'seller' of 'credit protection' synthetically acquires credit exposure to the sovereign entity, against whose creditworthiness payments under the derivative are pegged. A corporate 'buyer' of such protection effectively hedges itself against sovereign default risk.

FIGURE 1
SUPPLY AND CASH FLOWS UNDER EXPORT SUPPLY CONTRACT AND RELATED CREDIT DERIVATIVE.

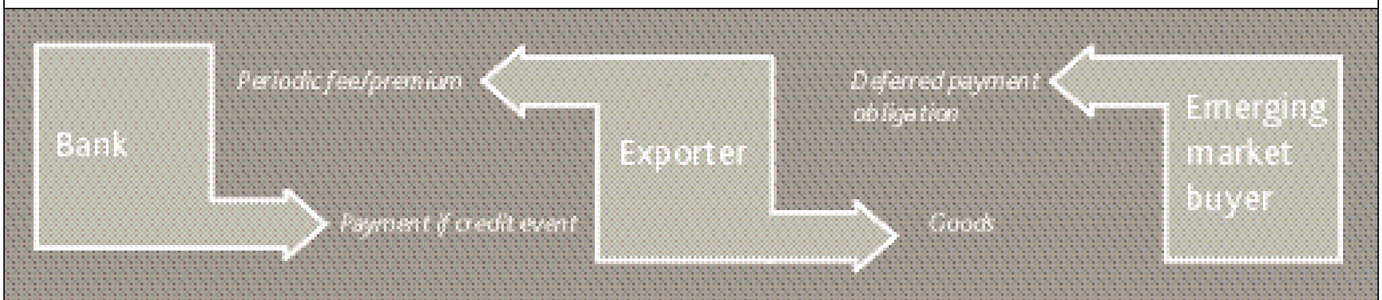

Figure 1 sets out, in simple terms, the relevant supply and cashflows. In much the same way as an exporter would pay to an insurance company a premium for export credit insurance cover, so under a sovereign risk credit derivative the exporter would pay to a bank a fee for credit protection in respect of a named sovereign (or quasi-sovereign) – the 'reference entity'.

In return, the derivative contract would provide for a pre-determined payment to be made by the bank to the exporter on the occurrence of one or more 'credit events' (analogous to insurance market 'risk events') with respect to a generic class of debt obligations ('reference obligations') of the reference entity.

The generic nature of the credit protection implicit in the structure outlined in *Figure 1* – that is, one where the payout to the exporter is determined by reference to one or more reference obligations, as opposed to a specific deferred payment obligation – does not represent a perfect hedge against specific sovereign risk. Such 'basis' risk, as it is called, is undoubtedly a disadvantage of CDs over more traditional export credit insurance products (ECIPs) but is one that can be mitigated through appropriate documentation.

Basis risk may, in any event, be self-mitigating, the argument being that, even if a payment is not triggered under the strict terms of the derivative contract, the mere fact that the reference entity is at, or close to, formal default on its sovereign debt obligations will, of itself, increase the value of the derivative to the protection holder – value that can be realised in the market.

There follows a brief summary of the respective advantages and disadvantages of the two types of product.

ADVANTAGES OF CDS COMPARED WITH ECIPS.

▪ **Confidentiality.** Since the risk protection afforded by a CD is generic in nature, there is no need for the exporter to disclose to

the bank the exact nature of its exposure to the reference entity. Indeed there is, theoretically, no requirement for the exporter to have any reference entity exposure at all – a characteristic that markedly differentiates CDs from ECIPs and analogous insurance products.

▪ **Pricing.** Theoretically at least, the price that the exporter would be asked to pay for protection should much more accurately (than, say, an insurance premium) reflect the reference entity's true credit risk. This is as much a classic 'relative intermediation' argument (that is, that banks, as opposed to insurance companies, are relatively better at assessing, and therefore pricing, default risk) as a consequence of the fact that CDs, particularly in liquid markets, are price-accurate proxies for real credit exposures. Whether the price will be any better than corresponding insurance premiums is, of course, a different question – but one that is often answered (albeit by CD providers) in the affirmative.

▪ **Legal treatment.** CDs, provided they are structured correctly, are not insurance contracts. A recent English law opinion of leading counsel confirms this. As a consequence, they are not, unlike insurance contracts, vulnerable to avoidance for non-disclosure. As already mentioned, no disclosure to the protection provider is required at all.

▪ **Documentation.** Reasonably standardised International Swaps and Derivatives Association (ISDA) documentation exists to record CD transactions. That said, there is no specific precedent for sovereign risk CDs – existing precedents being focused exclusively on corporate reference entities – and negotiations are, by their nature, complex and intense.

▪ **Ancillary risk protection.** Sovereign risk CDs can be structured to mitigate both default risk and 'pure' sovereign risk such as inconvertibility, non-transferability, expropriation and the like.

DISADVANTAGES OF CDS COMPARED WITH ECIPS

▪ **Basis risk.** As we have seen, CDs provide only generic solutions to emerging market and other sovereign credit exposures and so may not be suitable for creditors seeking specific risk protection.

▪ **Defining the reference entity/reference obligations/credit events.** Again, as a consequence of the generic nature of the protection afforded, much effort needs to be directed at the key definitional components of the derivative, as it is these that drive any payout under the contract.

▪ **Illiquidity.** The sovereign risk CD market is illiquid, sellers of protection being, generally, in short supply. This may affect price, certainly in relation to seekers of longer-term protection.

▪ **Emerging market peculiarities.** In a distressed situation, it is almost impossible to predict an emerging market's legal environment with certainty. This creates problems not only in itself, but also gives rise to difficult questions of interpretation – particularly relevant in the context of generically-worded CD contracts, the payout under which depends on the outcome of the interpretative exercise. The catalyst for dispute is therefore high.

▪ **Recharacterisation risk.** While there is a high degree of certainty that CDs do not amount to insurance contracts, there exists, nevertheless, a theoretical risk of their recharacterisation as such, with the possibility, under English law, of avoidance of the contract as the ultimate sanction.

▪ **Unfamiliarity.** Many companies remain at an early stage when it comes to managing credit risk through derivatives. That said, we are seeing increasing interest and have recently (albeit too late to make a meaningful contribution to the pricing debate) been asked by a significant UK emerging markets exporter to undertake a comparative analysis of CD versus insurance premia.

SUMMARY. CDs represent a viable alternative or complement to traditional forms of export credit risk cover. While the market can be illiquid, protection is available, and while, in certain contexts, the risk protection acquired may not be perfect, CDs nevertheless offer a pragmatic solution to those seeking to hedge their credit exposures.

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This overview does not purport to give legal or other advice and should not be construed as such. It represents only the views of the author and not necessarily those of any other person.
Readers are also referred to the February 2002 edition of The Treasurer, *'Make Swaps for more security', by Chris Daniels and Claus Mikkelsen of Barclays Capital.*