# Managing sovereign and political risk

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Traditional values. Innovative ideas.

*How sovereign credit differs from traditional (corporate) credit*

# Traditional corporate credit analysis focuses on the 3 Cs

Cash flow (“ability”)

Character (“willingness”)

Collateral

# Sovereign cash flows are not the same as that of corporates …

**Equity interest in parastatal utilities**

**Donor funding**

**Taxation**

**Printing**

Raise money

GOVERNMENTS

Incur debt

**Private sector supplier credit**

**Publically issued Tbills and bonds**

**Bilateral foreign currency debt**

**Commercial banks loans**

**Foreign currency debt (multilateral int. FI)**

# Ability to repay impacted by

- Fiscal revenues vs. capital and recurring expenditure (wages, subsidies etc.)
- Flexibility often constrained
  - Ability of the government to cut back on expenses
  - Economic diversification (narrow based economies more vulnerable)
  - Economic wealth (low income economies more vulnerable)
  - Certain global factors (e.g. commodity prices)
- Cash flow waterfall

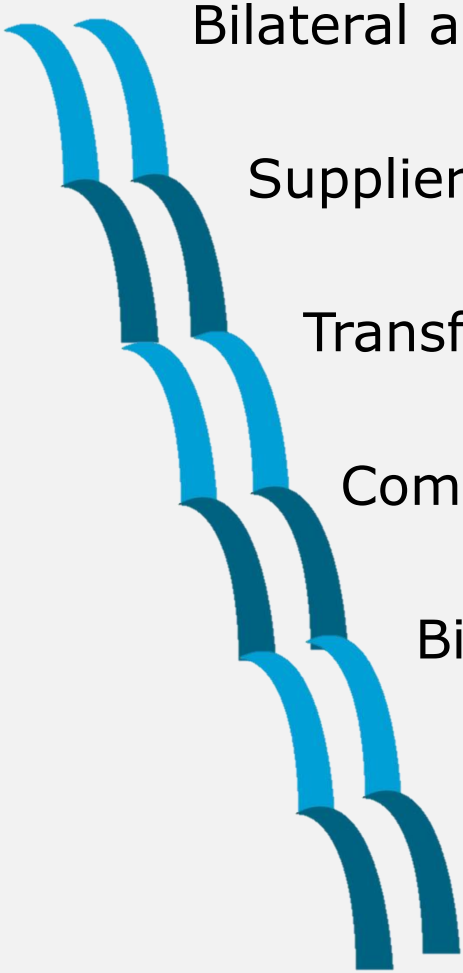
# Willingness to repay impacted by


In order to strike a balance, governments typically follow a **selective default approach**

# Four categories of political risk

1. **War & civil disturbance**
2. **Nationalisation & expropriation**
3. **Currency transfer & convertibility**
4. **Breach of contract**

# Unlike corporates, sovereigns tend to follow a waterfall default pattern…



| | |
|---|---|
| Bilateral aid agencies | *Co-lending* |
| Suppliers & contractors | *Payroll finance, micro finance* |
| Transfers to SOEs | *SOE exposures (e.g. IPP)* |
| Commercial banks | *Broader credit metrics* |
| Bilateral loans | *Inter-country trade relations* |
| Public debt | *Corporate debt* |
| Trade finance | |

*Managing sovereign and political risks*

*- practical considerations*

# 1 *Public debt exposures*

# Assessing risk changes – key fundamental variables to track

## Financial variables

- Economic structure and growth prospects
  - Real GDP growth
- Fiscal flexibility and performance
  - Change in net government debt / GDP %
  - Interest bill / government revenue
- External liquidity and international investment position
  - CA balance/GDP
  - Net narrow external debt/CA receipts %
- Monetary policy effectiveness
  - CPI inflation
- Institutional and governance effectiveness
  - World bank governance indicator

## Non-financial variables

- Institutional & governance effectiveness
  - World bank governance indicator

    1. Voice and accountability
    2. Political stability and lack of violence
    3. Government effectiveness
    4. Regulatory quality
    5. Rule of law
    6. Control of corruption

- Policy formulation/ execution effectiveness

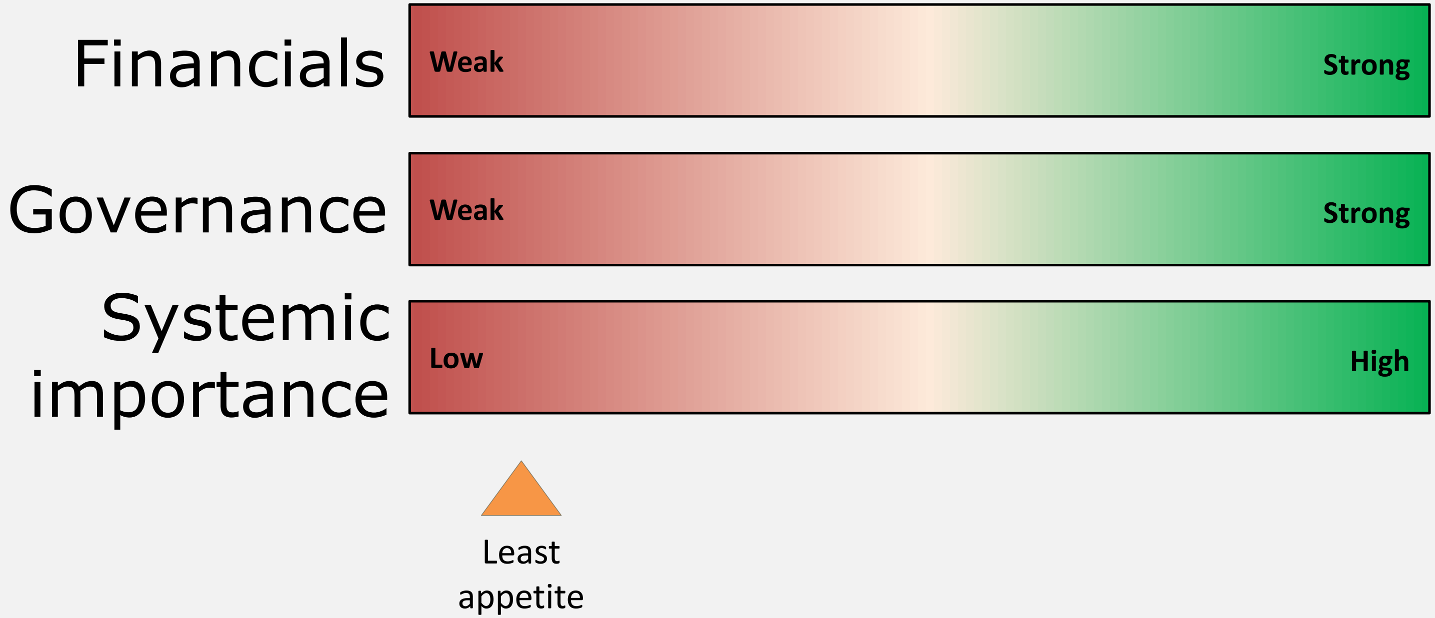
- Corruption index (World bank)

# Potential responses

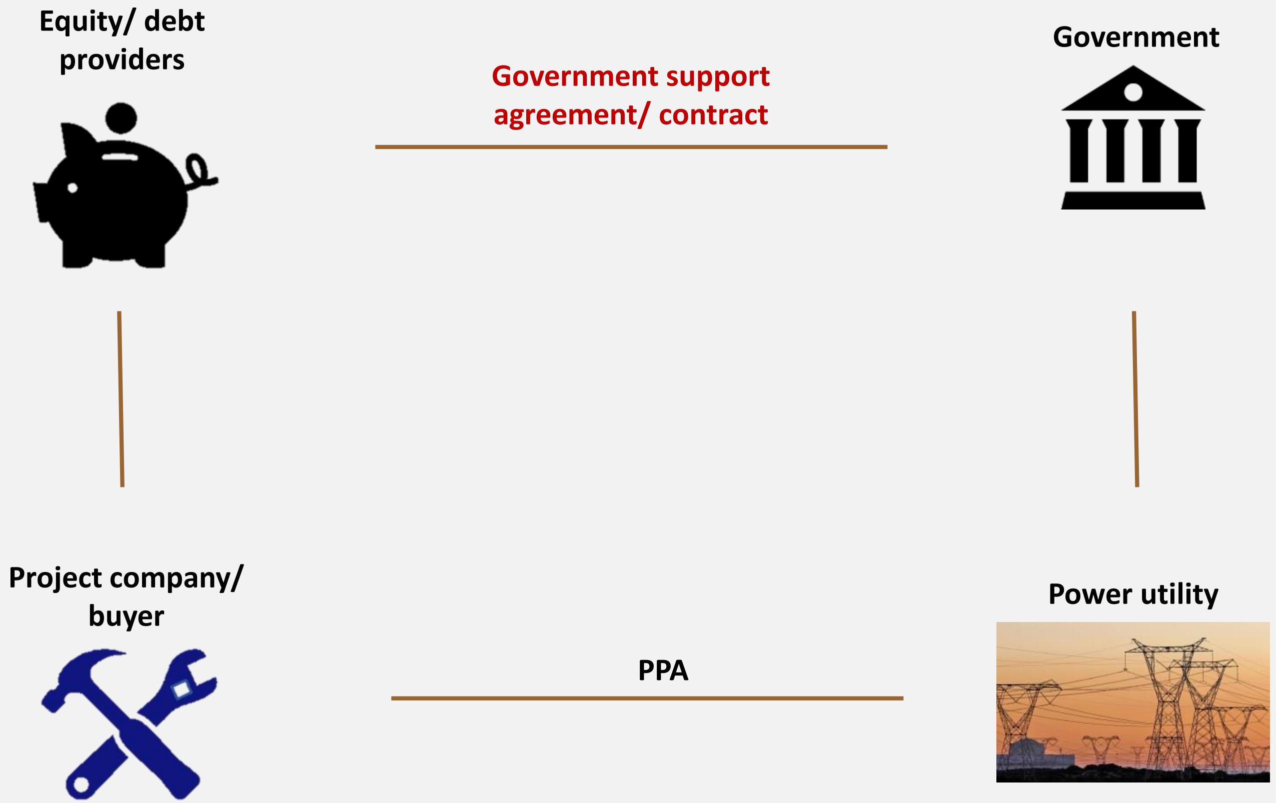
- HQLA portfolio vs. government debt portfolio
- Externalisation of capital
- Discretionary exposures limits
  - Country, tenor, product
- Broader credit origination responses
- Additional considerations when arranging or distributing public debt

# 2 *Lending exposures*

# Scaling of SOE direct lending risk limits – a framework to apply



# Using project finance techniques as a risk mitigant when dealing with SOE's



# Four categories of risk mitigants

## Insurance

- Insurance through an ECA
- PRI provided by multilateral (e.g. MIGA or IBRD)
- PRI provided by the private sector (e.g. Lloyds)

## Co-lending & risk sharing

- Co-lending alongside DFIs due to their influence
- Risk sharing principle (another lender with a vested interest in a country)

## Guarantee products

- Credit guarantees, can also provide liquidity support

## Country risk analysis/ other

- In-house team(s)
- External analysis
- Country limits
- Government incentives
- On-the-ground vs. desktop analysis

**We will not do a deal if we are not comfortable with the sovereign or the country, regardless of commerciality**

**We will not lend into a deal if we think we may need to rely on the PRI**

# Some things we just have to live with …

- Any risks not covered under the contract/ government support agreement
- Typically, there is a small uninsured portion of the PRI
- Compensation is never immediate (typically takes up to 2 or 3 years to resolve)
- Compensation will not always cover costs

# Airline example

**Another example…**

State policy orientated exposures
*- government asset divestments*

# Guiding principles for selective participation …

- Off-market transactions
- Reputational issues on assets
- Discomfort of parties involved

- New production capacity created
- Assets already owned by government
- Risk sharing with peer banks

**Portfolio limits**

- Total limit
- Public sector limit
- % of total book

# Conclusion

- Government credit risk depends on where in the "sovereign waterfall" the lending occurs
- There is direct and indirect sovereign risks to be aware of
- Political risk can be mitigated through a number of means, but the underlying commerciality of transactions should be the first line of defence
- Formal frameworks are needed to guide internal risk taking and governance processes

# Questions

FirstRand Limited ("FirstRand") is the second largest financial institution in Africa; its history tracing back to 1970 as an investment bank

The Group was established in its current form on the 1st of April, 1998

FirstRand is now one of the largest companies listed on the exchange operated by the JSE Limited, with a market capitalisation of c.USD16.5bn

FirstRand has 39 500 employees and total assets of USD89bn

# Background to FirstRand

- The FirstRand Group executes its strategy through its portfolio of operating franchises, FNB, RMB, WesBank and Ashburton
- RMB is the corporate and investment banking arm of FirstRand

FIRSTRAND

Listed holding company
(FirstRand Limited, JSE: FSR)

| FNB | RMB | WesBank | ASHBURTON INVESTMENTS |
|---|---|---|---|
| Retail and commercial banking | Corporate and investment banking | Instalment finance | Investment management |