Latin risk normalisation

by André Cappon *and* Guy Manuel

Has Latin American risk been tamed? To a large degree yes, although a few challenges remain.

Latin American economies have, over the last 5-10 years, demonstrated that they can put their financial houses in order. Inflation is now mostly under control, even in those countries that were experiencing hyper-inflation just a few years ago, such as Argentina or Brazil. Currencies have been remarkably stable, relative to previous history. The region has weathered the 'Tequila effect' of 1995, and is holding up remarkably well in view of the Asian crisis (Central Bank of Brazil showed considerable coolness under fire, and dealt professionally and successfully with the aftermath of 'Round One' last year). The yield curves observed in the Latin capital markets have lengthened considerably: not so long ago, in Brazil, three months was considered long term; today, long term means a couple of years. Latin stock markets have performed largely well, with volatility below their historical records.

The outlook is good. The giant of the region, Brazil, is sticking to a steady economic policy. Assuming President Cardoso is re-elected next November, reforms should continue and economic growth revive after the slowdown in 1997-98. Mercosul is very positive and will continue to bolster trade and prosperity in the Southern Cone. Mexico, the other major economy, is benefiting from North American growth.


BM&F: flying the flag for risk management

Equally important has been the emergence of a broad range of risk management tools, as well as a burgeoning risk management culture among Latin financial institutions.

BRAZIL IS CLEARLY in the lead. Its shining star is the derivatives exchange, Bolsa de Mercadorias e Futuros – BM&F. Consider the following: Brazil's world rank in terms of GNP is around eighth to tenth. The 'monetarisation' of the Brazilian economy, ie

Future challenges

One way or the other, Latin American economies now have a well-established risk management culture, and a panoply of necessary tools, be they local or offshore. Relative to Asian or East European emerging markets, they are much better positioned. But there are two main challenges remaining:

1 To maintain a stable macroeconomic and financial track record

2 To strengthen credit quality in the financial sector

The first of these is clearly the job of governments. Let us hope they will do it well.

The second is dependent on both governments and the financial institutions themselves. The banking and financial sectors of Latin America have been through a lot of restructuring and consolidation since the mid-1990s. A very positive phenomenon, from a credit quality perspective, has been the massive entry of some strong global banks: Santander, Hong Kong Shanghai Bank, BBV, etc. Local bank mergers have ensured that weak players have been absorbed by stronger ones.

Nevertheless, counterparty credit quality remains a key concern. Historical experience shows that the bank failure rate in Latin America is an order of magnitude higher than in developed economies. A long period of good news will be needed to reassure the markets. ❖

the ratio of financial assets to GNP, is still low at around 50% (as against over 300% for the US), as a result of the ravages of past inflation. Yet BM&F ranks consistently among the top five or so derivatives exchanges in the world!

BM&F has led the development of a thriving risk management industry. It has been a major and creative product innovator, and has launched a variety of products designed to deal effectively with the inflation/devaluation risks. The basic products are the DI or *depósito interbancario* (interbank deposit) rate, and the *cambio*, the interest rate product and the US dollar/Brazilian Real exchange rate.

As of the end of April 1998, the DI contract had annualised volume of 13.5m contracts per year, and swaps 16.4m. The *cambio*, which trades 6.5m contracts per year, has also been the basis of a family of fx products, including, in particular, flex options.

Stimulated by BM&F, the Brazilian banking industry has developed a thriving OTC market for risk management products. Brazil's know-how in this area is at the same level of sophistication as in any of the world's leading financial centres, and perhaps even more advanced since it has had to deal with high inflation and volatility, rudimentary market data and higher than usual counterparty credit risk.

The risk management industry is less advanced in the other Latin American countries. Argentina has tried to start a derivatives exchange for several years, most recently with help from Chicago Board of Trade. The project has been delayed several times, and has encountered a variety of difficulties. Mexico, Chile, Peru and the other countries of the region still do not have derivatives exchanges.

A key reason has been their dependence on the US capital markets and the US risk management industry. Just like Brazil, the other countries of the region come from a history of instability, inflation and devaluation, which have come under control only recently. But unlike Brazil, the other countries have dealt with instability by 'dollarising' their economy, more or less explicitly. Clearly Argentina has been most radical in this regard, with its successful 'convertibilidad' – the law that mandates convertibility of pesos into dollars and requires that each peso in circulation must be backed by a dollar of reserves.

The consequence of 'dollarisation' has been that the capital markets of the countries involved have in a sense moved off-shore, to the US dollar world. Risk management for an Argentine or Mexican bank can be done effectively and more cheaply in the highly liquid US market. When an Argentine bank wishes to do a swap, its first reaction is to call a swap desk in New York. When a Mexican bank needs to hedge a foreign exchange exposure, its first reaction is to trade Mexican Peso contracts on Chicago Mercantile Exchange.

To sum up, Latin risk is well on its way to normalisation. The remaining challenges are being addressed. Most importantly, while the *perception of risk* is still significant, there are many opportunities to make money, for the well-advised and alert player. ❖

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Credit risk flirtation

A particularly encouraging indicator of the normalisation of Latin risk is the thriving Latin credit derivatives market.

Credit derivatives as a class have finally come of age. These instruments enable participants to 'unbundle' credit risk from other risks, such as market risk.

According to recent reports, the overall notional volume of credit derivatives contracts outstanding was around $200 billion as of the end of 1997 (up from $50bn at the end of 1996). We estimate that about half of this volume concerns Latin risk.

In a typical transaction, a counterparty, say a foreign bank with a large credit exposure to Brazilian companies, is encountering a limit to its business, perhaps a regulatory constraint or an internally-imposed credit limit to Brazil. The business is highly profitable and the bank wishes to increase it. In the old days, this might have been difficult or impossible. The only risk reduction techniques were syndication or perhaps a loan sale, which involve high transaction costs, delays, and interfere with the customer relationship. Nowadays, the credit derivatives market offers an elegant and cost-effective solution.

It takes two ... to credit swap

In the basic credit default swap, the protection buyer pays a premium to the protection seller in exchange for a guarantee against possible loss due to the default or credit downgrading of a reference entity. In our example, the reference entity might be the Federal Republic of Brazil, which has a number of liquid, US dollar-denominated external bonds. Should there be a 'credit event', perhaps defined as a decline in the value of these bonds due to default or downgrading, the protection seller pays to the protection buyer an amount equivalent to the loss experienced by the reference asset.

As a result of the credit swap, the protection buyer has replaced a credit exposure to Brazil, a B-rated counterparty, with a credit exposure to the protection seller, typically a major bank with, say, an A or AA credit rating. This enables the protection buyer to continue lending to Brazilian companies, having eliminated a large part of the risk, the country risk, and obtained regulatory relief.

As a result of Isda's standardisation efforts, there are now well-accepted over-the-counter credit swap agreements, which help improve market liquidity. A dozen or so dealers, all major investment and commercial banks, are regularly making markets in credit derivatives. A few interdealer brokers, of which the most prominent is Prebon Yamane, help structure and intermediate most transactions among these dealers.

Thanks to such intermediaries, there is now an effective price discovery process for credit risk. According to Bryant Rother, head of Prebon's global credit derivatives group, the current premium for credit swaps for the major Latin American countries is as shown in the following table (in annual basis points):

Country\Tenor	6m	12m
Brazil	250	300
Mexico	200	240
Argentina	90	110

The increasing level of activity in the market – currently several Latin credit derivatives trades take place every day, each of which might have a notional value of $25 million – underscores the increased acceptance of Latin risk and the blossoming of techniques for managing it.

The next stage in the evolution of credit risk management may well be the launch of highly liquid exchange-traded credit derivatives. Most likely, these contracts will address emerging market credit risk, since that is where the demand is greatest. ❖

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