SSEI
Sanjay Saraf Educational Institute Pvt. Ltd.
A positive NPV Training Center

Lecture Note 9

COUNTRY RISK & STRESS TESTING

SUMMARY

COUNTRY RISK

Country risk is important to firms considering expansion opportunities involving a foreign country. It is also important to fund managers investing in foreign markets, banks making loans to foreign countries, and those considering buying bonds issued by foreign countries.

There are many components to the evaluation of country risk. Less developed countries encounter many problems as they try to grow their economies. Political upheavals, reductions in the market price of key exports, and civil wars are all liable to adversely affect the foreign firms investing in the country.

There are several services that score a country according to its risks and, in some cases, provide an in-depth analysis. The risks considered include economic risk, political risk, legal risk, the level of violence, and so on. Sometimes the risks are combined into a single measure.

Rating agencies such as Moody's, S&P, and Fitch provide country ratings for debt issued in foreign currency and debt issued in the local currency.

Political upheavals, reductions in the market price of key exports, and civil wars are all liable to lead to a default on debt. Some countries, such as Argentina, Brazil, and Paraguay, have defaulted many times on their debt. A default typically leads to existing debt being exchanged for new debt, or the existing debt being restructured in some way (e.g., with a lower interest rate, a lower principal, or a longer time for repayments). Typically, a default makes it difficult for a country to raise further debt for a period of time and is likely to hurt both its reputation and its economy.

SUMMARY
STRESS TESTING

Stress testing is an important forward-looking risk management tool. Tools such as VaR and ES usually rely on the assumption that the future will be like the past and, as a result, may fail to consider key risks. Even stressed VaR and stressed ES are based on stressed periods that have actually occurred in the past. The scenarios considered by stress testing (if carried out properly) should include those that reflect the current business environment and those that have never happened before.

Senior managers are liable to argue that stress testing leads to risk assessments that are unduly pessimistic and capital requirements that are too high. However, risk management does not mean that no risks should be taken. It simply means that risks should be understood and that actions be taken when they are unacceptable. It is important that both the board and senior management be fully committed to stress testing and consider the results from stress testing when making decisions. Stress testing should not be a game between a financial institution and its regulators with the objective of producing less severe outcomes so that capital requirements are not increased.

There are many ways in which stress-testing scenarios can be developed. Some are based on stressed periods from the past and can be regarded as extensions of stressed VaR and stressed ES measures. Others consider the impact of big changes in key variables. The most important stress tests are those which are based on the judgement of senior management and consider the risks they see on the horizon. Some of these risks might be totally new and require the development of scenario-specific models.