Amid the intensifying global market volatility of late, the term ‘sovereign risk’ was prominent in media and analyst commentary. The prevalent view was sovereign risk was a new development in markets, something that fund managers needed to develop new skills to deal with.

Contrary to this belief, sovereign risk factors have always been an integral part of making sound investment decisions. What seems to have happened, however, is that many investors had become complacent about sovereign risk assessment, particularly in the Eurozone. Simply assuming that all members of the single currency region would pursue improved public finances and fiscal strategies because they were obliged to under the Maastricht criteria has proven to be a mistake.

This note therefore discusses the meanings of the term ‘sovereign risk’ and how market participants consider and measure it.

What is sovereign risk?

’Sovereign risk’ refers to the risk that a government may default on its debt obligations. In general, when governments have bonds that are due to mature, they don't have sufficient tax receipts on hand to repay all the debt, so they re-enter the market to raise further money via a bond issuance. Sovereign risk thus includes ‘refinancing risk’, when a government is unable to raise sufficient new debt in the market (i.e. at reasonable market prices and in sufficient volume) to repay upcoming bond maturities. Sovereign risk can also be used to refer to a country imposing regulations, restricting the ability of issuers in that country to meet their obligations, such as foreign currency restrictions.

What are issues on sovereign risks clouding Europe now?

In terms of the current issues in Europe, the term sovereign risk has been used to widely categorise the large budget deficits and very high government debt levels of a number of countries, especially Portugal, Italy, Ireland, Greece and Spain. These countries, especially Greece, have both very high net debt levels and very high budget deficits, which are adding substantially to their debt burden. This ongoing accumulation of large deficits and debt is causing many in the market to question whether there is a higher risk that these countries may at some point not be able to repay bonds as they mature. A borrowing country that has higher budget deficit levels over a long period of time accumulates large government debt levels, giving that borrower less financial flexibility to borrow in the future. This makes these two indicators the key ones to watch when assessing sovereign risk.

How do we measure sovereign risk?

A common measure of sovereign default risk used by many investors is the sovereign risk rating that rating agencies such as Moody's, S&P, and Fitch assign to each borrower. Similar to the well known corporate bond credit ratings, sovereign risk ratings are based upon an assessment of both the ability and the willingness of a country to service its debt. These ratings take into account criteria that include the key economic and socio-political attributes of sovereign entities. The assessment considers solvency and liquidity factors in evaluating the economic ability to pay, while political criteria such as development level of government and institutions, the degree of integration into global financial networks, and constraining forces such as social unrest are all important in assessing the willingness to pay. Sovereign risk ratings are thus based mainly on economic factors, however, a country’s history as a borrower on global markets and political (governance) factors are also important.

The market is heavily influenced by rating agency actions because of their impact on actual investor behaviour, through the need to adhere to risk limits in portfolios, and because of their impact on general market psychology. Hence, the recent downgrade of Greece by S&P from investment grade to high yield was a big contributing factor in its government bond yields rising very sharply, despite the EUR 110bn aid package agreed with the EU and IMF at the end of April. Many investors simply have to sell out of non-investment grade bonds. For other investors, the decision to sell may have been made on the basis of a decline in sentiment toward Greek bonds.
In addition to uncertainties that still remained around the aid package in the near term, the market turned its attention from Greece’s immediate ability to refinance its redemptions to its medium term structural problems and its ability to resolve them. A higher risk of default was thus priced in, which was reflected in borrowing rates rising sharply.

**What is sovereign risk premium?**

Sovereign risk premium is essentially the yield premium that the market demands to hold a government’s debt. Government borrowing rates, or bond yields, are a synthesis of a wide range of factors, including economic factors (inflation expectations, output gap, interest rates, debt to GDP ratio etc), political/social factors, credibility, transparency and so on. When market participants take a less favourable view of a nation its bond yields are pushed higher. The increase in borrowing costs may in turn give rise to further deterioration in the country’s finances, thereby creating a negative feedback loop for the country and its ability to borrow funds.

When sovereign risk premiums increase, the market is in effect penalising the issuer of the debt for deteriorating conditions in the factors that go into yield valuations. Essentially, the driver of rates is the economy. But fundamentals can take a backseat when the market demonstrates ‘herd behaviour’ and/or irrationality due to uncertainties and lack of trust in a government to tackle its problems.

**Under which conditions would default risk increase?**

The risk of default increases under these conditions including:

- Deteriorating fiscal conditions
- Deep recession/depression
- Wars
- Political risk
- Social unrest
- Deflation
- Losing control over one’s sovereignty (including monetary policy and the ability to print its own money)

There is a distinction between regulatory risk and credit risk. The term ‘sovereign risk’ has recently appeared in the media not only in relation to the issues with Greece and other European peripheries, but also in discussing Australia. For the former, it’s a default probability related issue; for the latter, it’s a matter of perception about how certain are the ‘rules of the game’ for doing business in Australia. The Resource Super Profits tax (RSPT) has been represented by some commentators as an example of heightened sovereign risk in Australia. We believe this is a misuse of the term, but in any case it needs to be clearly distinguished from the more common use of the expression as they are very different concepts.

Another way the market expresses its view of sovereign risk is via sovereign credit default swaps (CDS). A CDS is a contract between two parties whereby the buyer of protection makes periodic payments to the seller, and in return receives a contracted amount if there is a credit event (such as a default). The buyer of protection may be an investor who owns a government’s bonds and, rather than selling them to the market prefers to ‘hedge’ the risk by buying a CDS. CDS are designed to offset risks such as defaults and bankruptcies. A protection buyer is similar to a buyer of insurance who buys protection against a future unknown event.

The amount of the regular payments that have to be made under a CDS are expressed as an interest margin or spread over money market rates. Hence, if CDS spreads are increasing, the market is telling us that it worries more about default probabilities and the protection against such event becomes more expensive. This is exactly what happened with Greek CDS spreads which have been on the rise since February.
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