

Reallocating country risk by contract

by Peter S. Smedresman, Moses & Singer LLP

For international banks, sovereign actions such as exchange controls are risks to be managed for their own account, transferred or shared with other institutions or customers. Banks in emerging market jurisdictions are themselves counterparties for other financial institutions, playing a crucial role in the allocation of sovereign risk in the trade finance market. This brief note will comment on some techniques utilised by banks to share country risk with other banks, and on the effectiveness of contractual provisions as a US legal matter.

The basic consensual vehicle for re-allocation of country risk is the familiar "PRI" – political risk insurance. While historically offered only by insurance companies and multilateral institutions for project financings, it has increasingly been offered by certain banks with appropriate market positions to cover trade finance transactions.

The risks covered in this sector are, typically, inconvertibility (i.e. inability to convert local currency to hard), transfer risk (i.e. inability to transmit hard currency out of a jurisdiction), and, in some cases, expropriation in some limited areas, i.e. seizure, or extended delay in returning, currency or other assets in local banks to support trade transaction or their financing.

At the risk of oversimplifying what is always a complex set of undertakings, several other key characteristics include: (1) the risks covered must be embodied in actions having legal content, i.e., laws, regulations, orders, administrative actions; (2) the customer must support a claim with a factual and documentary presentation; and (3) the payment of a claim is accompanied by turnover of contract rights, local currency, and any other assets that would help the provider recover via subrogation.

In the trade finance context, country risk protection is often cast as a bank-style guarantee (such as US Ex-Im Bank's political risk guaranty agreement). Such arrangements have even been structured by way of letters of credit (though unusual letters of credit they are!). However, country risk protection is best viewed as an insurance product regardless of format.

Another hybrid technique now encountered in the marketplace is interbank trade finance funding agreements with country-risk exceptions. Typically, a major international bank that does trade finance business in the emerging markets ("Bank A") will seek to obtain funding in hard currency from

another major bank ("Bank B") on the basis that if Bank A encounters repayment difficulties from local borrowers, then repayment in hard currency to Bank B is either (1) converted to a local currency obligation at the current exchange rate, or (2) postponed until the exchange controls (or other condition) is lifted - possibly indefinitely.

These arrangements range from preposterously one-sided to reasonably thoughtful, but none of them (in this author's experience, anyway) have given the party in Bank B's position the rights that any PRI provider would insist on. A few tips for the Bank Bs in facing these documents are:

- Only the sovereign risks attendant on trade financing should trigger defences – particularly exchange control. The definitions should be carefully reviewed. There is no reason for Bank B to accept the risk of civil unrest, expropriation of physical assets, or terrorism in this context. Commercial, or insolvency, risk should be excluded.
- Bank A should not be permitted to cherry-pick amongst its local borrower loans. Then Bank B should be able to insist that it bear the defined risk only if Bank A can match the loan that Bank B has funded with the loan Bank A has made to a local Borrower, and that has not been repaid due to the country risk event. Records to support this determination should be kept.
- If country risk events are activated, and proven, then Bank B should acquire Bank A's rights to local currency deposits, rights against its own borrower if possible, and any other collateral or guaranties.

These funding agreements present serious risk of loss, which can be only moderately mitigated by adoption of those pointers. If Bank B does not have a strategic use for the local currency (the market advantage employed by some PRI providers), it will

have a difficult time justifying accepting the risks these arrangements present, absent meaningful commercial considerations.

Another interesting application of country risk wording in the trade finance markets involves letters of credit written by branches of major international banks. Bank A, a bank headquartered in a hard-currency jurisdiction, issues letters of credit payable in hard currency from a branch in an emerging market jurisdiction. The beneficiaries require that the credit be confirmed by Bank B through an office in a hard currency jurisdiction, so they are shielded from country risk. Bank B, as confirmer, is generally entitled to reimbursement from Bank A. Bank A introduces country risk wording, comparable to that appearing in the trade funding agreements mentioned above, in a document made binding in the confirmer. Bank A is correct in believing the language is necessary to transfer the risk, since the law governing the issuer-confirmer relationship may not be the same as the law governing Bank A's letter of credit. Here, one must review the specific rules applicable to letters of credit, including the UCP, the ISP (in the case of standbys), Article 5 of the

Uniform Commercial Code, or other applicable law or industry rules.

What is the legal efficacy of country risk reallocation amongst banks by contract? From a US legal standpoint, the US courts gave the signal in the ultimate outcome of the Citibank Manila¹ litigation (as it is referred to among bankers): at least as far as wholesale market participants are concerned, the risk of exchange controls may be allocated between the parties, provided the language is clear enough. In that famous case, the US courts found, at bottom, that simply designating the branch of issue of the bank obligation (deposit confirmation, in that case) wasn't enough. The techniques discussed above are a sensible approach to satisfying the US courts' insistence on specificity.

Designation of branches of account still has almost talismanic significance in interbank agreements as an indicator of country risk. The peril of over-reliance on this single indicator, though, has increased. There is decisional law in the US to the effect that merely indicating New York as a place of payment will probably be insufficient to fix liability at a New York branch of an international bank if the

MOSES & SINGER LLP

COUNSELORS AT LAW

REPRESENTATION OF FINANCIAL INSTITUTIONS HAS BEEN A PRINCIPAL FOCUS OF OUR PRACTICE SINCE THE FIRM'S FOUNDING IN 1919. CURRENTLY, WE REPRESENT MANY LEADING U.S. AND INTERNATIONAL BANKS (FREQUENTLY AS AGENT FOR SYNDICATES) IN A WIDE VARIETY OF TRANSACTIONS, CONCENTRATING IN FINANCINGS INVOLVING SPECIALIZED COLLATERAL AND CREDIT SUPPORT.

1301 AVENUE OF THE AMERICAS
NEW YORK, NY 10019-6076
212.554.7800 FAX: 212.554.7700
WWW.MOESSINGER.COM

instrument indicates that another branch is identified as the place where the liability in question is booked.² In insolvency, the New York bank superintendent, as liquidator of a New York branch of a foreign bank, may recognise as eligible claims only transactions that are documented as being entered into with the branch. The lesson to be learned, again, is the necessity for precision and specificity in contract drafting.

Notes:

¹ Wells Fargo Asia Ltd. v. Citibank N.A., 936 F.2d 723 (2d Cir. 1991).

² Finanz AG v. Banco Economico, S.A., 192 F.3d 240 (2nd Cir. 1999). In this case, the instrument in

question was an *aval* of a trade note entered into by "Banco Economico, S.A., Cayman Islands Branch."

Author:

Peter S. Smedresman, Partner

Moses & Singer LLP

1301 Avenue of the Americas

New York

New York 10019

US

Tel: +1 212 554 7869

Fax: +1 212 554 7700

Email: psmedresman@mosessinger.com