Argentina’s financial crisis has affected the region’s markets far more deeply than many expected. It has changed the way investors and banks approach risk in Latin America.

Argentina’s crisis spawned some catchy but inaccurate metaphors. The slowest-moving train wreck is one of the most memorable. Many international investors saw trouble coming in plenty of time and got out of the way. It was believed at the time that Argentina’s collapse marked the end of financial market contagion in the developing world. As everyone now knows, that was not the case at all.

Brazil’s public debt burden is reaching unsustainable levels, South American companies are finding credit harder to obtain than ever, and staying current on debt payments is an everyday struggle for many corporations. Nobody expected a crisis of such severity or complexity in Argentina. Uruguay’s banks are collapsing. Venezuela is on the ropes. The implications are far-reaching since these events, especially the disaster in Argentina, have profoundly changed how markets view risk in Latin America.

Until recently, banks and traders would model their portfolios and measure risk using financial market data and pay relatively little attention to unquantifiable political developments. International banks have spent millions and hired regiments of brilliant mathematicians to develop systems to help manage and exploit risk. By their nature, these systems are essentially backward-looking and reactive. But as the events of the last year have shown, managing risk often depends more on intuition than on data spat out by computers.

Argentina’s collapse has taught investors that political risk is probably the most difficult type of risk to manage. Says Carlos Guimarães, head of investment banking at Salomon Smith Barney, “I think the exaggerated volatility in Brazil was triggered as a consequence of the sizable losses of investors and financial institutions in Argentina. Argentina has taken away the market’s ability to withstand uncertainty.” Growing numbers of investors are choosing to stay away not just from Argentina and Latin America, but also from those companies that do a lot of business in the region. Francisco Alzuru, a portfolio manager at Hansberger Global Funds, with $1 billion under management, including European bank stocks, says, “I would like to say that I can live with global risk, but I am not sure of the extent of the domestic risk that [these banks] are facing in some Latin American countries. I don’t know what the ultimate impact [will be] on their books.” He has recently sold European bank stocks exposed to Latin America.

Tanya Azarchs, managing director in financial services at Standard & Poor’s, says that however sophisticated risk management models may be they “cannot keep you from making unwise strategic decisions. [Argentina] was a country where banks such as Citi and Fleet made good money for a century. Even during the crises in the 1980s, their local operations continued to make money.” She adds that, “You cannot ask a risk management system to signal that you are going to have a political candidate you don’t like get elected, or that the perception of the manageability of the debt in people’s minds will change.”

In hindsight, the weak and inept government of Argentine President Fernando de la Rúa turned a serious problem into a cataclysm. Elected in 1999, he inherited a stagnant economy with a high but manageable debt load, yet markets only began giving up on his government in early 2001 when asset prices began to slide. The Buenos Aires Merval index, measured in dollars, has dropped 85% since then.

At the same time, investor confidence began to take a battering in the US, starting with last year’s terrorist attacks in New York and Washington. Few could have predicted that some of the most valuable US companies, Enron and WorldCom, would be riddled with fraud and go bankrupt, that
Arthur Andersen would fold, or that some of Wall Street’s finest banks, Citigroup and Merrill Lynch, would be subject to ridicule in the media and come under investigation by the Securities and Exchange Commission and by New York State Attorney General Eliot Spitzer.

Risk management software is not designed or intended to account for events such as these. It relies on collecting and processing financial market data, which are themselves formed by economic data, political news, and changes in market liquidity and capital flows. The increased ease of communication and sophistication of these systems injects greater market volatility by allowing traders to respond instantaneously to events in distant countries, which they often understand only vaguely.

Unreasonable Risk
Risk management systems rely on financial market indicators to signal trouble, but alarms can ring late. David Hendler, analyst at independent research firm CreditSights, says, “Good risk managers decide how much [debt] a credit can absorb before their obligations become unsustainable. Lenders and institutional investors based their decisions on the feeling that the US government would make sure that Argentina and Brazil would do right by international bondholders.” The International Monetary Fund’s refusal, at the behest of the US Treasury, to bail out Argentina stunned investors. Even though Brazil has received a $30 billion IMF rescue package, no one knows how long the Fund will support the incoming government. “The banks are scared of Latin America,” says Hendler. “Argentina showed them you [did not] have [someone] on the other side of the table you could reason with. They realized that this is a condition they didn’t factor into bond or loan pricing. It forced them to scale back in Brazil, even though they say it is too big and too diversified [to fail]. They are not sticking around to see how it pans out.”

In particular, Argentina has thrown into sharp relief the complexity of managing full-service banks in the unpredictable environment of the emerging markets. Citigroup and JP Morgan have achieved colossal economies of scale, offering almost every conceivable financial service. This diversification implies that trouble in one product, market or region will not threaten the banks' overall stability or profitability. Divisions are meant to complement each other. Their investment banking business benefits from the commercial bank’s corporate contacts and vice versa. This design is facing its greatest test now as Citigroup faces trouble on several fronts simultaneously. JP Morgan has no local commercial banking business in Argentina or Brazil.

Although Argentina accounts for a dwindling part of Citigroup’s balance sheet, the bank’s risk profile there is complex. Citigroup owns the country’s seventh-largest bank, Citibank Argentina, with $7.1 billion in assets at the end of last year. This is far greater than its cross-border portfolio of Argentine loans and securities, which the bank says is less than 0.5% of it balance sheet. Citigroup has taken $1.4 billion in charges on its balance sheet since the first quarter for Argentina, and continues to incur losses related to loans, making a $281 million increase in provisions in the third quarter. Citigroup says its net local investment in Brazil at the end of September totaled $3.5 billion, down from $5.2 billion six months earlier. It had a further $4.6 billion in cross-border claims on third parties in Brazil, down by a quarter from March.

Managing loan portfolios, especially in Latin American countries with relatively illiquid financial systems is hard, and only adds to the challenges of coping with risk. It is easy to sell a portfolio of liquid bonds, but it is hard to cut off financing to a corporate client in a time of need even when alarms are ringing. This applies to banks with deep roots in the region such as Citibank, with over 100 years’ history in Latin America. The bank does have the advantage of having a broad and diversified portfolio of products and clients that allows considerable flexibility in managing exposures. Says Guimarães, of Salomon Smith Barney, “In moments like this, [it is important to] keep your market share and maintain dialogue with your main customers and weather the storm. We have a larger franchise than [other foreign banks], which allows us to have multi-product capabilities. We have not in any way exited relationships, countries or products.”
Richie Prager, Bank of America's president of Latin America, adds that, “Clearly certain kinds of risks are more liquid, such as securities. It is more delicate dealing with syndicated and bilateral loans and long-dated derivatives contracts.” Yet banks can be brutal when necessary. Prager says, “We were prepared to work very quickly on bilateral transactions [in Argentina], selling where we could.” Bank of America has cut its exposure by 22% in Argentina this year to $500 million at the end of September, from $541 million at the end of July. It has cut its Brazilian exposure by 22% to $1.55 billion at the end of September from $1.99 billion at the end of July. The bank also closed its subsidiary in Colombia and reduced its presence in Venezuela and Chile in 2000 to focus on Mexico and Brazil, but is careful in these markets too. “We started changing well over a year ago in the nature of our exposure,” says Prager. “We only [took] exposure to key clients, and where there was [long-term] derivative exposure we would deal with it with credit protection.”

**European Losses**

The problems facing US banks in Latin America pale in comparison to their European rivals with their big retail franchises and balance sheets stuffed with dodgy government securities. Citigroup has $8.1 billion in assets in Brazil, of which around 12% consist of government securities. According to Standard & Poor's, Santander Central Hispano had $19 billion in assets in Brazil through its subsidiaries, Banespa and Banco Santander Meridional, at the end of the first quarter. One-third of these assets are held in government securities, so a large loss in this portfolio would wipe out a significant portion of SCH’s investment in Brazil. ABN AMRO’s Brazilian subsidiary, Banco ABN AMRO Real, has $11.1 billion in assets and $2.6 billion in government securities. In Argentina, banks such as Banco Bilbao Vizcaya Argentaria’s subsidiary, Banco Francés, cannot even estimate how great their losses are and when they are likely to recover them. Banco Francés, Argentina’s third-largest private sector bank, has not reported any results since March, when it held $502.4 million in securities. In September 2001, this portfolio was worth $3.44 billion.

Hansberger's Alzuru has sold stock in European banks such as Santander, in favor of others such as Barclays, Royal Bank of Scotland in the UK and France's Société Générale because they are not heavily exposed to Latin America. "They offer a value that is comparable to Santander or IntesaBci, but without the political risk, which is unquantifiable," he says. "They have a different set of risks associated with the global economy, but those risks are more measurable. Eventually those banks will take a haircut, take new debt with a new interest rate and write some of it down. When and how, I have no idea. Other institutions have more quantifiable risks and they are trading at similar valuations and are more attractive right now."
Citigroup should be able to absorb trouble in Brazil — barring serious problems elsewhere — with little difficulty. S&P’s Azarchs points out that it has $16 billion in annual earnings and a $1.08 trillion balance sheet. She says, “Even if they wrote off every penny of Brazil it would be OK. In isolation, Brazil is not that big a deal for them.”

**Full-Service Frailties**

During the booming 1990s, full-service banks were considered the wave of the future because they could win investment banking business based on their commercial banking relationships. However, the old-line investment banks are looking healthier and more agile these days. James Healy, global head of emerging markets at Credit Suisse First Boston, says, “In the markets in Latin America, we focus on liability management, some selective lending and on proprietary trading. We do not find ourselves with large concentrations of risk in one region or another that are systemic, because we try to maintain liquidity and agility in trading positions.” Healy says CSFB is more heavily concentrated in Asia than Latin America this year and has become more attuned to the need to contain risk by operating in liquid markets, wherever possible. “At all times we work hard to make sure that these aren't sticky positions but positions that we can adjust as opportunities and risks change.”
But managing the expectations of the ratings agencies and communicating with skeptical shareholders is tricky. Ironically, the full-service firms’ diversity, which makes them so flexible, also makes them appear vulnerable to investors. Dick Dahlberg, co-head of US active investing at Grantham Mayo Van Otterloo, with $1 billion under management, says he is underweight Citigroup, but not because of its exposure in Latin America. “Citi is so big and has so much capital that [Latin America] is not a big deal in proportion to its size. The biggest risk in the US is litigation.” But difficulties in core markets may affect the willingness of Citigroup and that of other big US and European banks to take on more risk in the emerging markets. This matters more than ever as capital markets remain closed and the international banking industry consolidates into a smaller number of increasingly large institutions.

As decision-making becomes concentrated among fewer and fewer people, attitudes to risk become all the more important. It only takes a few senior bankers in New York, Madrid or London to cut financing for an entire industry, country or region. The accuracy and quality of the information they receive is therefore more important than ever. Although many banks develop their own risk management technology, most risk management systems are based on similar fundamental principles, according to RiskMetrics Group, a risk management technology company that was part of JP Morgan until it was spun off in 1998. RiskMetrics’ Latin American clients include investment banks, central banks and multinationals. DataMetrics, a service division of the company, feeds data from the currency, interest rate, equity, and futures and options markets into two software tools, RiskManager and CreditManager. RiskManager allows clients to measure levels of market risk and CreditManager measures credit risk. For example, they can measure the credit risk on a Cemex bond against an emerging markets benchmark.

Jorge Mina, head of risk modeling at RiskMetrics, makes no exaggerated claims for his product. “Risk management technology is not a replacement for informed decision-making. Our tools allow risk managers to get all the relevant data they need to do the analysis. It is a tool that is going to facilitate their job. For example, these statistical tools cannot assess the risk of low-probability scenarios arising from political crises, but provide a platform to perform stress tests from scenarios defined by risk managers.” Healy at CSFB agrees, “I would differentiate between models that quantify risk [and those that] are trying to tell you how and when to trade. When markets are more volatile, the risk numbers increase and then management has to take remedial measures to adjust the risk.”

Herd Mentality

Making sense of risk is not easy. In Brazil this year, the real has weakened steadily and bond spreads widened as Luiz Inácio Lula da Silva began his triumphant march to the presidency. The currency was trading at R$2.307 to the dollar in January, began weakening in April, and fell to a low of R$4 in mid-October. But a sudden dip at the end of July, followed by a short spike at the beginning of August, probably indicates that institutions reacted simultaneously on information from their risk management systems, says Healy. “When markets become more volatile, a number of institutions can start hitting their value-at-risk limits at the same time and the technology is instructing them to reduce [their exposure] at the same time. That can create more volatility,” he says. Proprietary trading desks at some banks have probably made, and lost, a lot of money out of this volatility. Says Healy, “I think people that are robotic tend to get themselves into trouble. The markets in Brazil provided a great deal of opportunity if you were able to identify what was herd behavior in market prices and what was more economic fundamentals. We were not a seller with the herd there and we tried to trade it opportunistically.”
Helping Latin American companies and governments manage risk has become an increasingly important new source of revenue for banks such as CSFB, Morgan Stanley, Citigroup and Bank of America, which have opened or expanded their derivatives trading desks in Brazil and Mexico. Borrowers, particularly those in Brazil, with dollar debt and local currency revenues need to hedge currency and exchange rate fluctuations. But the cost of these swaps has ballooned since the beginning of the year from around 4% of the loan’s value to around 34% in mid-November, according to Jorge Larangeira, trader on the local markets desk at Dresdner Bank Brasil in São Paulo. SSB’s Guimarães says, “Products which mitigate risk are at a premium. We have worked very closely with the structured finance and derivatives [departments]. Many issuers are going to access the capital markets through credit enhancements and structured transactions.”

Naturally, weakening credit risk is less of a concern for pure investment banks than for their multi-service rivals. Indeed, it is an opportunity. Corrado Varoli, head of investment banking for Latin America at Goldman Sachs, expects more Brazilian companies to restructure their debts in the next few months. Borrowers will have to hire advisors to negotiate fresh terms with lenders, and these mandates will help replace some of the investment banks’ lost revenues from the dormant M&A, equity and bond markets. The telecom, power and media sectors are particularly vulnerable. Four companies in these sectors are already in restructuring talks. Eletropaulo Metropolitana, owned by US energy company AES Corp, BCP Telecommunicações, a cellular telephone joint venture including BellSouth Corp., and Brazil’s Banco Safra, and Brazil’s biggest paper and pulp company Klabin have all begun to renegotiate debts this year.

**Double Hit**

Varoli says investment banks have an advantage over the likes of JP Morgan and Citigroup when it comes to pitching for a restructuring mandate simply because they are not creditors. Globo Comunicações e Participações hired Goldman Sachs and restructuring firm Houlihan Lokey Howard & Zukin Capital to advise it on restructuring some $1.5 billion in debt, including $900 million in bonds, originally arranged by JP Morgan, Salomon Smith Barney and Goldman Sachs. Investment bankers say Globo’s decision to hire Goldman and Houlihan signals that companies are not comfortable choosing creditor banks to advise on restructuring their debts.

Of course, the commercial banks disagree. Bank of America’s Prager says, “We are helping three corporates restructure their balance sheets and in all three cases we are a creditor. I want a healthy company at the end of the day and one with access to capital.” Banks insist that a restructuring team can act in the interests of the borrower and operate independently of their colleagues trying to collect on the loan. But Prager says deals favoring debtors over creditors “may not be the best long term solution if they alienate all the creditors for the future.”

Investment banks run entirely different risks involving their public image and political roles. In Argentina, the government wants to punish investment banks that helped sell $95 billion in international bonds during the 1990s by excluding them from bidding for the potentially lucrative mandate to restructure those same bonds. The Economy Ministry’s document calling for bids states that, “It is important that the [bidding] institution has not participated as lead manager in any sovereign debt transaction for Argentina in the 24 months prior to December 2001.” According to Dealogic Bondware, a database, JP Morgan lead-managed 43 Argentine issues totaling $19.2 billion and Salomon Smith Barney was involved in 22 issues worth $11.5 billion. Deutsche Bank, Credit Suisse First Boston, Morgan Stanley and Goldman Sachs ranked third, fourth, fifth and sixth respectively.

Banks that sold a smaller proportion of Argentina’s bonds include Merrill Lynch, UBS, BNP Paribas and ABN AMRO. Argentina’s government, though understandably bitter at its predicament, is unlikely to help itself much by rejecting the most experienced investment banks out of hand. Azarchs points out that investment banks are simply intermediaries. “Maybe that causes political problems occasionally, where the government cannot understand the position, but they cannot be blamed for being there to facilitate the transaction their clients want. They never had long-term ambitions to be an on-the-ground operation.”
Weight of Brazil
Much depends on Lula, who takes over as president in January. If he convinces the markets that he will indeed take decisive measures to control the public finances and improve the government’s debt profile, risk will continue to dissipate. Guimarães says Lula has undergone “a very relevant transformation, which is enormously positive, but the markets are still unsure if this transformation is here to stay. I happen to believe that it is real, but the market at large needs more comfort.”

As long as confidence continues to recover, the cost of servicing the debt will fall. Just as important, faith in Latin America as a whole would also begin to revive. Debt dynamics will begin working in Brazil’s favor as the real revalues and real interest rates ease. Relief in Brazil would lead markets to reassess risk elsewhere in the region. But if Brazil were to default, it would wreak devastation on financial markets in Latin America and across the developing world. It could also put a dent in the international strategies of some of the world’s biggest financial institutions. LF