The Impact of Sovereign Defaults on Corporate Credit Risk

General Principles

A sovereign default occurs when a country is unable or unwilling to meet its debt obligations to external creditors.

In principle, the sovereign should be the lowest risk entity in any country, because

Inflating currency	Tax rates
Most sovereigns have control over the money supply in their local currency and can inflate away debt in their local currency.	Sovereigns can adjust tax rates or levy special taxes to giving government more control over their income other entities.

In practice, there are exceptions to the government being the lowest risk in a country.

Highly dollarized economies	Policy choices
Countries like Argentina, Panama, and Uruguay have less control over the currency supply. Corporations that earn a sizeable portion of their income in foreign markets can be lower risk than the sovereign (called piercing the sovereign ceiling).	Governments don't always choose to inflate currency or levy taxes to avoid default.

Specific examples

Ghana's sovereign default provides a recent exception to the country ceiling. In early December 2022, the Ghanaian government exchanged existing bonds for new ones with a longer period of maturity. This is considered a default, because creditors of the Ghanaian government would receive payment later than agreed when the bonds were initially issued.

Ghana chose not to inflate their currency and the only tax increase the government employed prior to the default to increase revenue, was to raise value-added-taxes (VAT) from 12.5% to 15%. Ghana's sovereign rating worsened to Selective Default (SD), without causing all other entities in the country to enter default. The country's reputation suffered considerable damage, but the government maintained that the effects of sudden increases in taxes or money supply would have exceeded the costs of the reputational loss.

Mozambique has seen two downgrades from S&P (in October 2024 and again in February 2025) putting it at risk of sovereign default. Turmoil after the most recent election has placed strain on the government budget on both the income side due to lower tax revenue and on the expenditure side due to increased security costs.

KPMG

Implications for Lenders

Lenders with exposure to customers within a market that experiences a sovereign default would have to reassess the credit risk of any exposure to the sovereign itself, but other credit exposures may also be impacted.

For the Sovereign exposure itself, the key elements in reassessing the risk include:

Specific exposure

Some sovereigns have specified which bonds would not receive payments. Impacts can thus vary according to the exact bond issue held.

Default specifics

Ghana's example shows that a default could lead to a loss because of the timing on which payments are received, rather than a loss of principle.

Lender's market position

Holders of bonds could be treated differently during defaults based on location (local vs foreign), or systemic importance.

Most lender have generic expectations of loss given a default event which apply to performing Sovereign exposure. Once default occurs, lenders should adapt their expected loss parameters towards the actual observed values for their exposure.

Exposure to customers who are subject to the defaulting sovereign, reassessment is also required.

Currency impacts

Currency volatility could from attempts to avoid default or based on the default event. This can affect corporates by increasing forex expenses, but also forex income. Risk could increase or decrease.

Tax changes

Taxation would affect post tax income directly, but also has knock-on effects from other economic participants

Access to funding

Some investors are disallowed from investing in jurisdictions where sovereigns have defaulted. This causes difficulty accessing alternative funding.

Economic contraction

Sovereign defaults frequently trigger economic downturns or recessions. This could adversely affect cash flow, as well as sales volumes, leading to reduced profits.

Rating reassessment

Corporations with ratings from external rating agencies could see those ratings downgraded in response to the more challenging operating environment

Contagion effect

Sovereign defaults could create contagion risks, especially within the same region. Thus downgrades could spread to neighbouring countries.

kpmg.com/socialmedia

Maria van der Valk
Partner, FRM Credit and Capital Risk
M: +27 82 712 7878
maria.vandervalk@kpmg.co.za

Henri Boshoff
Senior Manager, FRM Credit and Capital Risk
M: +27822383733
henri.boshoff@kpmg.co.za