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Arrangement on Officially Supported Export Credits

PREMIUM AND RELATED CONDITIONS: EXPLANATION OF THE PREMIUM RULES OF THE ARRANGEMENT ON OFFICIALLY SUPPORTED EXPORT CREDITS (THE KNAEPEN PACKAGE)

This document provides a description and explanation of the rules related to premium in the Arrangement on Officially Supported Export Credits that were adopted when the Knaepen Package was agreed in June 1997. It replaces TD/CONSENSUS(99)53, which is now obsolete in view of recent changes to the Arrangement text.

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**PREMIUM AND RELATED CONDITIONS: EXPLANATION OF THE PREMIUM RULES OF
THE ARRANGEMENT ON OFFICIALLY SUPPORTED EXPORT CREDITS
(THE KNAEPEN PACKAGE)**

I. Introduction

1. The objectives of the Knaepen Package¹, as reflected in Article 22 of the Arrangement on Officially Supported Export Credits (the “Arrangement”), are to ensure that Participants to the Arrangement charge premium rates in addition to interest charges that:

- i. cover the risk of non-repayment of export credits (*i.e.* credit risk); and
- ii. are not inadequate to cover long-term operating costs and losses² associated with the provision of export credits.

2. Another stated purpose of the Knaepen Package is premium rate convergence, which although not easily measured or defined, is a general outcome that can be expected when the two above-mentioned objectives are met.

3. The rules and principles of the Knaepen Package were designed with the perspective of the exporter in mind. This means that they are meant to provide for a level playing field with regard to the premium cost of official export credit support for exporters in competition for overseas sales. Since official export credit support is provided through insurance, guarantees and direct credits, these different systems are taken into account in the premium rules; mainly through differentials in the required Minimum Premium Rates (MPRs) for various types of products.

4. Although the MPRs are defined as minimum rates for sovereign and country credit risks, they apply irrespective of whether the buyer/borrower is a private or public entity. Thus, in effect the MPRs are floor rates that must be respected whenever country and buyer risk³ is covered.

¹ The Knaepen Package was concluded on 20 June 1997 and integrated formally into the Arrangement in December 1997. The actual rules of the Arrangement related to premium can be found in Articles 22 - 28, 43, 44 and Annexes V through VIII. References in this document to the “Knaepen Package” should be understood to represent these articles and annexes as a whole.

² This obligation is in relation to the list of prohibited subsidies, *i.e.* Item (j) of Annex I of the WTO Agreement on Subsidies and Countervailing Measures (ASCM), which prohibits the provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.

³ The term “buyer risk” should be understood to include the concept of “borrower risk” to cover cases when the buyer is not the ultimate party responsible for repaying the export credit (or when repayment has been guaranteed by *e.g.* a financial institution).

5. The rules of the Knaepen Package came into force on 1 April 1999, and are applicable to almost all business covered by the Arrangement⁴. Whilst these rules must be observed when providing an official export credit, the decision to provide such credit is the responsibility of each Participant (*i.e.* the Knaepen Package does not, in any way, have an impact on cover policy or portfolio management).

II. Key Elements of the Knaepen Package

(a) *Minimum Premium Rates (MPRs)*

6. As mentioned in the introduction, the most fundamental aspect of the premium rules in the Arrangement is the MPR. Article 23 of the Arrangement stipulates that “*the Participants shall charge no less than the applicable Minimum Premium Rate (MPR) for country and sovereign credit risk, irrespective of whether the buyer/borrower is a private or public entity.*”

(i) *Application of the MPR*

7. MPRs have been established for seven of the eight country risk classifications, with there being no MPRs for countries classified in Category “Zero”⁵, as the level of country risk in these countries is considered to be negligible. Nonetheless, the Knaepen Package prohibits Export Credit Agencies (ECAs) from charging premium rates that “undercut private market pricing” for transactions in Category Zero countries.

8. In addition, it is expected that Participants will charge premium in excess of the applicable MPRs for the very highest risk countries in Category 7, however, the incremental amount above the applicable MPR is left to the discretion of each Participant, subject to the general obligation to cover long-term operating costs and losses.

(ii) *Calculation of the MPR*

9. The MPRs are expressed in percentages of the principal value of the credit as if the premium were collected on an up-front basis at the “zero point”⁶. However, since Export Credit Agencies (ECAs) collect premium in different ways (*e.g.* as an up-front fee or a margin charged in addition to the interest rate) and at various times (*e.g.* some ECAs collect premium payments on a pro-rata basis as a credit is

⁴ The specific rules on premium, including the MPRs, neither apply to transactions covered by Annex I of the Arrangement (Sector Understanding on Ships) nor Part 1 (Large Aircraft Sector Understanding or LASU) of Annex III (Sector Understanding Export Credits for Civil Aircraft).

⁵ High Income OECD countries are, by definition, classified in Category Zero along with any other countries classified according to the normal procedures that are deemed to be of a similar risk level. The “High Income” designation is determined by the World Bank on an annual basis according to per capita GNI. Any OECD country classified in Category Zero by virtue of its High Income status remains classified in Category Zero until it falls below the High Income GNI threshold for two consecutive years, at which time the country's classification should be reviewed according to the normal country classification procedures. Any OECD country above the High Income threshold for two consecutive years shall be classified, by definition, in Category Zero. Such classification takes effect immediately after the OECD Secretariat has communicated a country's status as determined by the World Bank.

⁶ The zero point is defined as the date of the first drawing in case of a buyer credit or the first delivery in case of a supply contract.

disbursed), the net present value of the stream of premium income is calculated using an agreed set of currency-differentiated discount rates⁷; this ensures comparability between different ECA premium collection practices.

10. A premium which is at risk, *i.e.* is financed, must bear a separate premium for the portion at risk. Should, for any reason, a disbursement fall into the repayment period (*i.e.* disbursements effected after the starting point of the credit), the part of the premium attributable to that disbursement will not be regarded as being at risk. Thus, only a simple discounting back to time zero will apply.

11. The applicable MPR for a given transaction is determined by six factors:

- i. the applicable country risk classification of the buyer/borrower's country;
- ii. whether buyer risk is covered; *i.e.* whether cover is strictly limited to the five country risks defined in Article 24 a) of the Arrangement;
- iii. the time at risk (*i.e.* the Horizon of Risk or HOR), which for the purposes of the MPRs is defined as the time of the first disbursement of a credit through the final repayment;
- iv. the percentage of cover for the five country credit risks (see Paragraph 16);
- v. the "quality" of the export credit product; and
- vi. whether any country risk mitigation or exclusion technique has been used.

12. Based on these factors, the following mathematical formula is used to calculate the applicable MPR for an export credit:

$$\text{MPR} = ((a * \text{HOR}) + b) * (\text{PC}/0.95) * \text{QPF} * \text{PCF} * (1 - \text{MEF}) * \text{BRF}$$

where:

- a and b are coefficients associated with the applicable Country Risk Category
- HOR is the horizon of risk
- PC is the percentage of cover for country risk
- QPF is the quality of product factor
- PCF is the percentage of cover factor
- MEF is the country risk mitigation/exclusion factor
- BRF is the buyer risk cover factor

⁷ The following rules apply to the selection of the appropriate discount rate: (1) if any part of the premium is collected after the starting point of the credit (as defined in the Arrangement), the discount rate applied to the whole flow of premium income is the prevailing Commercial Interest Reference Rate (CIRR) base rate. For currencies with a three-tier CIRR system, the relevant (to the repayment term of the transaction) base rate is applied; (2) for premium collected in full after the first drawing/disbursement but before the starting point of the credit, the discount rate applied to the flow of premium income is the six-month average of the CIRR base rate for the currency in question. This rate is calculated twice a year, in January and July, and remains in force for a six-month period. For currencies with a three-tier CIRR system, the 5-year base rate is used.

13. A detailed explanation of this formula, including the various coefficients and variables used in it is provided in Annex 1.

(b) Country Risk Classification

14. In calculating the MPR for a transaction, the applicable country risk classification is the classification of the buyer's country, unless: (1) security in the form of an irrevocable, unconditional, on-demand, legally valid and enforceable guarantee of the total debt repayment obligation for the entire duration of the credit is provided by an entity, creditworthy in relation to the size of the guaranteed debt, in a third country, in which case the applicable country risk classification may be that of the country in which the guarantor is located; or (2) a classified⁸ multilateral or regional institution is acting either as borrower or guarantor for the transaction, in which case the applicable country risk classification may be that of the specific multilateral or regional institution involved.

15. The criteria and conditions relating to the application of a country risk classification according to the situations described above are provided in Annex 2.

(i) The Country Risk Classification Methodology

16. Countries are classified according to the likelihood of whether they will service their external debts (*i.e.* country credit risk). The five elements of country credit risk are:

- i. general moratorium on repayments decreed by the buyer's/borrower's/guarantor's government or by that agency of a country through which repayment is effected;
- ii. political events and/or economic difficulties arising outside the country of the notifying Participant or legislative/administrative measures taken outside the country of the notifying Participant which prevent or delay the transfer of funds paid over in respect of the credit;
- iii. legal provisions adopted in the buyer's/borrower's country declaring repayments made in local currency to be a valid discharge of the debt, notwithstanding that, as a result of fluctuations in exchange rates, such repayments, when converted into the currency of the credit, no longer covers the amount of the debt at the date of the transfer of funds;
- iv. any other measure or decision of the government of a foreign country which prevents repayment under a credit; and
- v. cases of *force majeure* occurring outside the country of the notifying Participant, *i.e.* war (including civil war), expropriation, revolution, riot, civil disturbances, cyclones, floods, earthquakes, eruptions, tidal waves and nuclear accidents.

⁸ The list of classified multilateral and regional institutions is available on the OECD's website. The classifications are reviewed on a regular basis, and procedures have been established whereby new institutions may be nominated for review on an *ad-hoc* basis.

17. The classification of countries is achieved through the application of a methodology, which is comprised of two basic components:

- **The Country Risk Assessment Model** (the CRAM), which produces a quantitative assessment of country credit risk, based, for each country, on three groups of risk indicators: the payment experience of the Participants, the financial situation and the economic situation. The methodology of the Model consists of different steps including the assessment of the three groups of risk indicators, and the combination and flexible weighting of the risk indicator groups.
- **The qualitative assessment of the Model results**, considered country-by-country to integrate the political risk and/or other risk factors not taken into account in full or in part by the Model. If appropriate, this may lead to an adjustment to the quantitative Model assessment to reflect the final assessment of the country credit risk.

18. A detailed description of the CRAM is provided in Annex 3.

19. The outcome of the CRAM is an objective starting point for the final assessment of the country risk. The CRAM outcome is transformed into a classification on a fixed scale of eight risk categories. Where appropriate, the resulting risk category is adjusted for qualitative risks related to the political situation and to other risk factors not included in the quantitative CRAM, in accordance with procedures agreed by the Participants. The final classification, based only on valid country risk elements, is a consensus decision of the sub-Group of Country Risk Experts, that involves the country risk experts of the participating ECAs.

20. The sub-Group of Country Risk Experts meets several times a year. These meetings are organised so as to guarantee that every country is reviewed each time a fundamental change is noticed and at least once a year. The meetings are confidential and no official reports of the deliberations are made.

21. When a country is re-classified, Participants are required to charge premium rates at or above the MPRs associated with the new Country Risk Category, no later than five working days after the re-classification has been communicated by the Secretariat.

22. The list of prevailing country risk classifications is published after each meeting on the OECD's website.

(c) The Quality of Export Credit Products

23. The MPRs are differentiated to take account of the quality of export credit products and percentage of cover provided. The differentiation is based on the exporter's perspective (*i.e.* to neutralise the competitive effect arising from the differing qualities of product provided to the exporter/financial institution). In practice the quality of an export credit product is a function of whether the product is insurance, guarantee or direct credit/financing, and for insurance products whether cover of interest during the claims waiting period (*i.e.* the period between the due date of payment by the buyer/borrower and the date that the insurer is liable to reimburse the exporter/financial institution) is provided without a surcharge.

24. All existing export credit products offered by the Participants are classified into one of the three product categories which are:

- Below standard product, *i.e.* insurance without cover of interest during the claims waiting period and insurance with cover of interest during the claims waiting period with an appropriate premium surcharge;
- Standard product, *i.e.* insurance with cover of interest during the claims waiting period without an appropriate premium surcharge and direct credit/financing; and
- Above standard product, *i.e.* unconditional guarantees.

(d) Risk Mitigation and Exclusion Techniques

25. When country risk (comprised of the five elements defined in paragraph 16) is mitigated or excluded for a particular transaction, the applicable MPR may be lowered. In order to lower the applicable MPR through the application of a Country Risk Mitigation/Exclusion Factor (MEF) in the MPR formula, it is necessary to meet the specific criteria and conditions set out in Annex 4.

26. With respect to country risk **mitigation** techniques, the applicable MPR as well as the criteria and conditions under which the MEF may be applied are described in Annex 4. The list of risk mitigation techniques is as follows⁹:

- Offshore Future Flow Structure Combined with Offshore Escrow Account
- Offshore Hard Security
- Offshore Asset-Based Security
- Offshore Asset-Secured and Asset-Based Financing
- Co-financing with International Financial Institutions (IFIs)
- Local Currency Financing
- Third Country Insurance or Conditional Guarantee
- Debtor Representing a Better Risk Than the Sovereign

27. The application of more than one of the country risk mitigation techniques listed above does not have a direct cumulative impact on the applicable MEF. The selection of an appropriate MEF to reflect the combination of country risk mitigation techniques must take into account the possible overlapping impact of two or more techniques on identical country credit risks. In the case of overlapping, only the best quality security is normally considered in determining the appropriate, applicable MEF.

⁹ As stated in Annex VII of the Arrangement, the use of the last two risk mitigation techniques (Third Country Insurance or Conditional Guarantee and Debtor Representing a Better Risk Than the Sovereign) is subject to further discussions among the Participants. Accordingly, no MEFs have been established for these techniques.

28. The list of country risk mitigation techniques is not intended to be a closed list, and the Participants are obliged to monitor and review the body of experience with the use of these techniques including the applicable criteria, conditions, circumstances and MEFs.

29. With respect to the **exclusion** of selected country credit risk elements from official export credit cover:

- In situations where only the first three country credit risk elements are excluded in their totality from cover, a MEF of 0.5 may be applied.
- In situations where only the fourth and fifth country credit risk elements are excluded in their totality from cover, a MEF of 0.2 may be applied.

(e) Review of the Level of the MPRs

30. Several mechanisms have been developed to assess the adequacy of MPRs and to allow, if necessary, for adjustments, either upwards or downwards. These mechanisms are known as the Premium Feedback Tools (PFTs), and are comprised of two review mechanisms generally based on accounting principles (the Final Loss and Provisioning PFTs) and a third that compares the MPRs with private market pricing of risk (the Private Market Indicators or PMIs).

31. The “accounting” PFTs assess the validity of the MPRs on an aggregate, country risk category and horizon of risk basis according to the Participants' actual results in relation to the country and sovereign credit risk of export credits subject to the MPRs.

32. The PMIs are comprised of four sets of private market pricing as follows: sovereign bonds, syndicated loans, the forfait market and a broad sample of corporate bonds.

33. All of these tools are used in parallel to monitor and adjust the MPRs.

(f) Review of the Knaepen Package

34. The Knaepen Package and its operational tools are subject to review on an ongoing basis to ensure their continuing validity in the light of experience and other developments. In the first instance, this work is carried out by the Working Group of Experts on Premia and Related Conditions, which is a sub-group of the Participants.

ANNEX 1

CALCULATION OF THE MINIMUM PREMIUM RATES

The formula for calculating the applicable MPR for an export credit is:

$$\text{MPR} = ((a * \text{HOR}) + b) * (\text{PC}/0.95) * \text{QPF} * \text{PCF} * (1 - \text{MEF}) * \text{BRF}$$

where:

- a and b are coefficients associated with the applicable Country Risk Category
- HOR is the horizon of risk
- PC is the percentage of cover
- QPF is the quality of product factor
- PCF is the percentage of cover factor
- MEF is the country risk mitigation/exclusion factor
- BRF is the buyer risk cover factor

The values for coefficients a and b are obtained from the following table:

	Country Risk Category							
	0	1	2	3	4	5	6	7
a	n/a	0.100	0.225	0.392	0.585	0.780	0.950	1.120
b	n/a	0.350	0.350	0.400	0.500	0.800	1.200	1.800

The **Horizon of Risk (HOR)** is calculated as follows:

For standard repayment profiles (*i.e.* equal semi-annual repayments of principal):

$$\text{HOR} = (\text{length of the disbursement period} * 0.5) + \text{the length of the repayment period}$$

For non-standard repayment profiles, the equivalent repayment period (expressed in terms of equal, semi-annual instalments) is calculated using the following formula:

$$\text{HOR} = (\text{average weighted life of the repayment period} - 0.25) / 0.5$$

The use of years or months in the formula has no impact on the calculation as long as the same unit is used for the disbursement and repayment periods.

The **Percentage of Cover (PC)** expressed as a decimal value (*i.e.* 95 per cent is expressed as 0.95)

The **Quality of Product Factor (QPF)** is obtained from the following table:

Product Quality	Country Risk Category							
	0	1	2	3	4	5	6	7
below standard	n/a	0.9965	0.9935	0.9850	0.9825	0.9825	0.9800	0.9800
standard	n/a	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000
above standard	n/a	1.0035	1.0065	1.0150	1.0175	1.0175	1.0200	1.0200

The **Percentage of Cover Factor (PCF)** is determined as follows:

For $PC \leq 0.95$, $PCF = 1$

For $PC > 0.95$, $PCF = 1 + (PC - 0.95) / 0.05$ * percentage of cover coefficient

	Country Risk Category							
	0	1	2	3	4	5	6	7
percentage of cover coefficient	n/a	0.00000	0.00337	0.00489	0.01639	0.03657	0.05878	0.08598

The **Country Risk Mitigation/Exclusion Factor (MEF)** is determined as follows:

For export credits with no country risk mitigation, $MEF = 0$

For export credits with country risk mitigation, the MEF is determined according to the criteria set out in Annex VII.

The **Buyer Risk Cover Factor (BRF)** is determined as follows:

When cover for buyer risk is excluded completely, $BRF = 0.90$

When cover for buyer risk is not excluded, $BRF = 1$

ANNEX 2

CRITERIA AND CONDITIONS GOVERNING THE APPLICATION OF A COUNTRY RISK CLASSIFICATION REFLECTING A THIRD COUNTRY GUARANTOR OR A MULTILATERAL OR REGIONAL INSTITUTION

PURPOSE

This Annex provides the criteria and conditions that govern the application of a country risk classification reflecting a third country guarantor or a multilateral or regional institution according to the situations described in the first and second tirets of Article 23 e) of the Arrangement.

APPLICATION

Country Risk Classification Reflecting a Third Country Guarantor

Case 1: Guarantee for the Total Amount at Risk

When security in the form of a guarantee from an entity which is located outside of the country of the buyer/borrower is provided for the total amount at risk (*i.e.* principal and interest), the applicable Country Risk Classification may be that of the country in which the guarantor is located when the following criteria are met:

- The guarantee covers the entire duration of the credit.
- The guarantee is irrevocable, unconditional and available on-demand.
- The guarantee is legally valid and capable of being enforced in the guarantor country's jurisdiction.
- The guarantee is for the five country credit risks on the buyer/borrower country.
- The guarantor is creditworthy in relation to the size of the guaranteed debt.
- The guarantor is subject to the monetary control and transfer regulations of the country in which it is located.
- If the guarantor is a subsidiary/parent of the guaranteed entity, Participants shall, on a case-by-case basis, determine whether: (1) in consideration of the relationship between the subsidiary/parent and the degree of legal commitment of the parent, the subsidiary/parent is legally and financially independent and could fulfil its payment obligations; (2) the subsidiary/parent could be affected by local events/regulations or sovereign intervention; and (3) the Head Office would in the event of a default regard itself as being liable.

Case 2: Guarantee Limited in Amount

When security in the form of a guarantee from an entity which is located outside of the country of the buyer/borrower is provided for a limited amount at risk (*i.e.* principal and interest), the applicable Country Risk Classification may be that of the country in which the guarantor is located for the portion of the credit subject to the guarantee. In addition to the criteria listed for Case 1, the guarantor's country classification may be applied only when either the guaranteed amount (principal amount plus the related interest) is either: (1) greater than or equal to 10 per cent of the principal plus the related interest; or (2) five million SDRs principal plus the related interest if the transaction exceeds 50 million SDRs.

For the unguaranteed portion, the applicable Country Risk Classification is that of the buyer country.

Country Risk Classification Reflecting a Multilateral or Regional Institution

Case 1: Guarantee for the Total Amount at Risk

When security in the form of a guarantee from a classified multilateral or regional institution is provided for the total amount at risk (*i.e.* principal and interest), the applicable Country Risk Classification may be that of the multilateral or regional institution when the following criteria are met:

- The guarantee covers the entire duration of the credit.
- The guarantee is irrevocable, unconditional and available on-demand.
- The guarantee is for the five country credit risks on the buyer/borrower country.
- The guarantor is legally committed for the total amount of the credit.
- The repayments are made directly to the creditor.

Case 2: Guarantee Limited in Amount

When security in the form of a guarantee from a classified multilateral or regional institution is provided for a limited amount at risk (*i.e.* principal and interest), the applicable Country Risk Classification may be that of the multilateral or regional institution for the portion of the credit subject to the guarantee. In addition to the criteria listed for Case 1, the multilateral or regional institution's classification may be applied only when either the guaranteed amount (principal amount plus the related interest) is either: (1) greater than or equal to 10 per cent of the principal plus the related interest; or (2) five million SDRs principal plus the related interest if the transaction exceeds 50 million SDRs.

For the unguaranteed portion, the applicable Country Risk Classification is that of the buyer country.

Case 3: Multilateral or Regional Institution as the Borrower

When a classified multilateral or regional institution is the borrower, the applicable Country Risk Classification may be that of the multilateral or regional institution.

Classification of Multilateral or Regional Institutions

Multilateral and regional institutions shall be eligible for classification if the institution is generally exempt from the monetary control and transfer regulations of the country in which it is located. Such institutions shall be classified in Country Risk Categories 0 through 7 on a case-by-case basis according to an assessment of the risk of each on its own merits and in consideration of whether:

- the institution has statutory and financial independence;
- all of the institution's assets are immune from nationalisation or confiscation;
- the institution has full freedom of transfer and conversion of funds;
- the institution is not subject to government intervention in the country where it is located;
- the institution has tax immunity; and
- there is an obligation of all its Member countries to supply additional capital to meet the institution's obligations.

The assessment should also take into consideration the historical payment record in situations of country credit risks default either in the country where it is located or in a buyer/borrower country; and any other factors which may be deemed appropriate in the assessment process.

The list of classified multilateral and regional institutions is not closed and a Participant may nominate an institution for review according to the above-listed considerations. The classifications of multilateral and regional institutions shall be made public by the Participants.

ANNEX 3

DESCRIPTION OF THE COUNTRY RISK ASSESSMENT MODEL

To guide the common classification of countries, a quantitative Country Risk Assessment Model (CRAM) was developed. The aim of the CRAM is to assess the likelihood that a country will service its external debts. The selection and the weighting of the indicators in the CRAM have been based on economic theory, econometric research and judgments of experienced country risk experts. The predictive value of the CRAM has, several times, been successfully tested with historical simulations. The validity of the CRAM is monitored and, if appropriate, it may be further enhanced.

The CRAM integrates three groups of indicators (the list of mentioned individual indicators is not exhaustive):

- the payment experience of all the participating ECAs, whereby the indicators are differentiated according to the credit period; for debt rescheduling countries special attention is given to the experience under the rescheduling or refinancing agreements as well as on contracts concluded after the cut-off date as determined by the Paris Club; the payment experience of the international financial institutions is also taken into account;
- the financial situation of the country, based on liquidity indicators such as total external short-term debts and foreign exchange reserves, as well as on financial solvency indicators in a medium-term perspective such as total external debts and total external debt service, that are typically related to aggregates such as gross domestic product and/or foreign exchange revenues;
- the economic situation of the country, based on indicators for current policy performance (such as budgetary, monetary and balance of payments' aggregates) as well as on more structural indicators of a longer-term nature that measure growth potential (such as income level, savings rates or realised economic growth rates) and vulnerability (such as export diversification, aid dependency or smallness) of the economy.

Critical values have been determined for each individual indicator. The risk scorings for the different indicators are weighted to arrive at an aggregated assessment for each of the three groups of indicators. The risk scorings for these three separate groups are then combined to arrive at one scoring that is the outcome of the CRAM. The three groups of indicators are approximately attributed the same level of importance, meaning that a bad result on one of these groups is sufficient for a high-risk CRAM outcome.

A certain hierarchy of data sources has been drawn up with regard to the financial and economic data-input in the CRAM. In general, data of official international institutions (like the IMF, World Bank, BIS and OECD) are used. Other sources may be used when there is insufficient data or for comparison. Divergent data from different sources are critically and conservatively approached.

The common country risk classification takes into account the latest available information. To this end the CRAM, which is centrally run, is updated for each country each time important new information becomes available or when important sudden events may change the perceived country risk. New

financial/economic data from the official international organisations become available for most countries in principle at least once a year. Payment experience data are reported by the participating ECAs every quarter. To verify the data-input and to be informed of the latest developments, the updated outcome of the CRAM for each country is made available to the sub-Group of Country Risk Experts.

The details of the Country Risk Assessment Model are confidential and not published.

ANNEX 4

CRITERIA AND CONDITIONS GOVERNING THE APPLICATION OF COUNTRY RISK MITIGATION/EXCLUSION IN CALCULATING THE MINIMUM PREMIUM RATES

PURPOSE

This Annex provides detail on the use of country credit risk mitigation/exclusion techniques listed in Article 27 b) of the Arrangement; this includes the criteria, conditions and specific circumstances which apply to their use as well as the applicable MEFs.

GENERAL APPLICATION

For all country credit risk mitigation/exclusion techniques listed in Article 27 b) of the Arrangement:

- The listed MEFs are the maximum that would be envisaged in the best circumstances and should be justified on a case-by-case basis.
- Participants shall ascertain whether the security arrangements can be validly enforced in their legal/judicial environment.
- The MPR resulting from the use of country credit risk mitigation/exclusion techniques shall not undercut private market pricing under similar circumstances.
- In the case where a transaction is financed in parallel by other sources, any security retained in relation to the official export credit is treated, at least, *pari passu* with the same security held by the other sources.

SPECIFIC APPLICATION

1. *Offshore Future Flow Structure Combined with Offshore Escrow Account*

Definition:

A written document, such as a deed or a release or trustee arrangement, sealed and delivered to a third party, *i.e.* a person not party to the instrument, to be held by such third party until the fulfilment of certain conditions and then to be delivered by him to the other party to take effect. If the following criteria are satisfied subject to consideration of the additional factors listed, this technique can reduce or eliminate the transfer risks, mainly in the higher risk country categories.

Criteria:

- The escrow account is related to a foreign exchange-earning project and the flows into the escrow account are generated by the project itself and/or by other offshore export receivables.
- The escrow account is held offshore *i.e.* located outside the buyer/borrower country where there are very limited, transfer or other country risks (*i.e.* a country classified in Category 0).
- The escrow account is located in a first class bank which is not directly or indirectly controlled by interests of the buyer/borrower or by the country of the buyer/borrower.
- The funding of the account is secured through long-term or other appropriate contracts.
- The combination of the sources of revenues (*i.e.* generated by the project itself and/or the other sources) of the buyer/borrower flowing through the account are in hard currency and can reasonably be expected to be collectively sufficient for the service of the debt for the entire duration of the credit, and come from one or more creditworthy foreign customers located in better risk countries than the country of the buyer/borrower (*i.e.* normally countries classified in Category 0).
- The buyer/borrower irrevocably instructs the foreign customers to pay directly into the account (*i.e.* the payments are not forwarded through an account controlled by the buyer/borrower or through its country).
- The funds which have to be kept within the account are equal to at least six months of debt service. Where flexible repayment terms are being applied under a project finance structure, an amount equivalent to the actual six months debt service under such flexible terms are to be kept within the account; this amount may vary over time depending on the debt service profile.
- The buyer/borrower has restricted access to the account (*i.e.* only after payment of the debt service under the credit).
- The revenues deposited in the account are assigned to the lender as direct beneficiary, for the entire life of the credit.
- The opening of the account has received all the necessary legal authorisations from the local and any other appropriate authorities.
- The escrow account and contractual arrangements may not be conditional and/or revocable and/or limited in duration.

Additional Factors to be Taken into Consideration:

The technique applies subject to a case-by-case consideration of the above characteristics and, *inter alia*, with regard to:

- the country, the buyer/borrower (*i.e.* either public or private), the sector, the vulnerability in relation to the commodities or services involved, including their availability for the entire duration of the credit, the customers;
- the legal structures *e.g.* whether the mechanism is sufficiently immune against the influence of the buyer/borrower or its country;

- the degree to which the technique remains subject to government interference, renewal or withdrawal;
- whether the account would be sufficiently protected against project related risks;
- the amount which will flow into the account and the mechanism for the continuation of appropriate provision;
- the situation with regard to the Paris Club (*e.g.* possible exemption);
- the possible impact of country risks other than the transfer risk;
- the protection against the risks of the country where the account is located;
- the contracts with the customers, including their nature and duration; and
- the global amount of the expected foreign earnings in relation to the total amount of the credit.

Applicable MEF

The maximum applicable MEF is 0.20 unless:

Specific Case 1: The maximum applicable MEF is 0.40 if all of the following additional criteria are met:

- The creditor has a first priority interest in the escrow account and the long-term contracts.
- The buyer/borrower is a private entity being more than 80 per cent private ownership.
- Either the projected Loan Life Coverage Ratio (LLCR) averages at least 2.5:1 or the projected LLCR averages at least 2.0:1 and the projected Annual Debt Service Coverage Ratio (ADSCR) is not less than 1.0 at all times after the starting point of credit¹⁰.
- There is at least 12 months of debt service pre-funding in escrow, which shall be replenished after each call on the pre-funded amount.

Specific Case 2: The maximum applicable MEF is 0.30 if all of the following additional criteria are met:

- Either the LLCR averages at least 1.75:1, or there is at least 9 months of debt service pre-funding in escrow, which shall be replenished after each call on the pre-funded amount.

¹⁰. The calculations of LLCR and the ADSCR shall be made in accordance with the conventions normally applied by prudent international lenders to establish an agreed (central scenario) banking case at or near financial close, after completion of full (technical and economic) due diligence.

Common Understanding of the LLCR and ADSCR Ratios

The reference to “Loan Life Coverage Ratio (LLCR)” is intended to mean, with respect to the period over which senior debt is being amortised, the ratio of (a) the net present value of the net forecasted cash flows, including the amount of any debt service reserve, available for payment of senior debt service discounted by the weighted average interest rate of the senior debt to (b) the total senior debt outstanding.

The LLCR allows banks and ECAs to take a risk-adjusted, long-term view of the adequacy of cashflow to service debt (principal and interest) throughout the life of the loan.

The reference to “Annual Debt Service Cover Ratio (ADSCR)” is intended to mean, as at any forecast date, the ratio of: (i) projected net cash flow available for payment of senior debt service for the relevant period to (ii) amount of interest, financing costs and principal of senior debt payable by the borrower for such period. The ADSCR mentioned in paragraph 6.1.1a) should be understood to be a minimum DSCR of 1.0 and shall be calculated on a projected basis.

The ADSCR allows banks and ECAs to determine the adequacy of cashflow to service debt (principal and interest) at any particular repayment date (which sets a point in time for determining the beginning or end of a particular 12-month period).

The objective in using ADSCR and LLCR ratios in Risk Mitigation Technique 1 is to provide a measure of the cashflow available for debt service which is included within the security package of lenders through any offshore account.

The calculations of LLCR and ADSCR shall be made in accordance with the conventions normally applied by prudent lenders to establish an agreed (central scenario) banking case at or near financial close (after completion of full technical and economic due diligence) and from time to time during the life of the project to monitor, in accordance with prudent banking practice, compliance with covenants relating to these ratios.

The debt service pre-funding requirement can be funded in cash or in other forms equivalent to cash (*e.g.* through the issuance of an irrevocable, unconditional and payable at first demand L/C by a highly creditworthy international bank, acceptable to the ECAs and the international lenders involved in the transaction).

A transaction seeking a discount under this technique should not achieve its viability through the granting of a discount on premia. A discount shall only be granted on the basis of the project’s economic viability and soundness, and when the transaction fulfils the requirements set out in the specification form. This check should be done at financial close when all of the relevant information is available on a reliable basis.

2. *Offshore Hard Security*

Definition:

Security in the form of offshore first or second priority pledges or assignments of securities held offshore by a shareholder of the buyer/borrower or by the buyer/borrower itself, or cash on deposit in an offshore account.

Criteria:

- The securities are defined as publicly-listed stocks and bonds issued by entities located in a better risk country located outside the buyer/borrower country and traded on exchanges in countries classified in Category 0.
- The cash is defined as deposits in hard currencies of countries classified in Category 0 or treasuries in such hard currencies issued by countries classified in Category 0.
- The security is unconditional and irrevocable for the entire duration of the credit.
- The country where the security is located represents a better risk than the buyer/borrower country and would normally be a country classified in Category 0.
- The security is beyond the reach and jurisdiction of the buyer/borrower.
- The prudently-assessed projected market value of the securities corresponds throughout the repayment period to the amount of the outstanding debt covered by the security.
- In any event, the cash deposit or the prudential value of the securities (which should cover both Principal and Interest) shall be for (1) not less than 10 per cent of the Principal amount plus the related Interest, or (2) five million SDRs Principal plus the related Interest if the transaction exceeds 50 million SDRs.
- The security can be legally and unconditionally realised in any event of default (*i.e.* of country credit risks in the buyer/borrower country).
- The proceeds of the securities or of the cash deposit can be freely converted into the currency of the credit or in another hard currency.
- In the event of default, the securities are directly transferred to the creditor, or the cash deposit is paid directly to the creditor for the appropriate amount.

Additional Factors to be Taken into Consideration:

The technique applies normally to all countries, buyers/borrowers and sectors, subject to a case-by-case consideration of the above characteristics and, *inter alia*, with regard to:

- The implications of the ownership (either public or private) of the securities or of the cash deposit, *e.g.* with regard to the likelihood of the realisation of this security in case of public debtors.
- The prospective value of the securities and the likelihood of realisation in relation to the entity, the sector and the country from which they originate.
- The legal environment.

Applicable MEF

The specific MEF to be applied shall:

- Reflect the degree of potential externalisation subject, *inter alia*, to the continuing value of the assets, as well as the possible uncertainties with regard to the realisation of the security;
- Be determined case-by-case to reflect, *inter alia*, on a basis, the value of the security provided in relation to the principal value of the credit and the applicable country risk classification of the country in which the security is located.

The value of cash security shall be taken at no more than 80 per cent and the value of stocks or bonds shall be taken at no more than 35 per cent of its prudential valuation.

3. Offshore Asset-Based Security

Definition:

Security in the form of first priority mortgages on real (*i.e.* immovable) assets which are held offshore.

Criteria:

- The security is unconditional and irrevocable for the entire duration of the credit.
- The real assets have a prudently-assessed projected market value and represent for the owner a substantial equity stake. This projected value corresponds throughout the repayment period with the amount of the outstanding debt on the buyer/borrower.
- The security can be legally and unconditionally realised in any event of default (*e.g.* of country credit risks in the buyer/borrower country).
- The proceeds can be converted into the currency of the credit or in another hard currency.
- In the event of default the appropriate proceeds are paid or assigned directly to the creditor.
- The country where the security can be enforced represents a better-risk category than the buyer/borrower country, *i.e.* it is normally ranked in the best-risk categories.

Additional Factors to be Taken into Consideration:

The technique applies normally to all countries, buyers/borrowers and sectors, subject to a case-by-case consideration of the above characteristics and, *inter alia*, with regard to:

- The implications of the ownership of the real assets (either public or private), *e.g.* with regard to the likelihood of the realisation of this security in case of public owners.
- The nature of the real assets (*e.g.* sector) which may impact on the continuity in their value and on the likelihood of realisation.
- The legal environment.

Applicable MEF

The specific MEF to be applied shall:

- Reflect the degree of potential externalisation subject, *inter alia*, to the continuing value of the assets, as well as the possible uncertainties with regard to the realisation of the security; and
- Be determined case-by-case to reflect, *inter alia*, on a basis, the value of the security provided in relation to the principal value of the credit and the applicable country risk classification of the country in which the security is located.

The difference between the MPR resulting from the application of this technique and the MPR which would apply absent mitigation shall be no greater than 15 per cent of the difference between the MPR which would apply absent risk mitigation and the MPR which would result from the application of the country risk classification of the country in which the asset is located.

In the following circumstances, the pricing implications apply on a basis as outlined below:

- The security (which should cover both Principal and Interest) is limited in amount on a uniform basis for the entire duration of the credit and for (1) not less than 10 per cent of the Principal amount plus the related Interest, or (2) five million SDRs Principal plus the related Interest if the transaction exceeds 50 million SDRs; in this case the pricing implication applies on a pro-rata basis to the guaranteed Principal/the Principal amount of the credit.
- The security (which should cover both Principal and Interest) is limited in amount on a non-uniform basis for the entire duration of the credit and for (1) not less than 10 per cent of the Principal amount plus the related Interest or (2) five million SDRs Principal plus the related Interest if the transaction exceeds 50 million SDRs. In this case the pricing implication applies on a pro-rata basis derived from the use of the average weighted life concept.

4. Offshore Asset-Secured and Asset-Based Financing

Definition:

Security in the form of an offshore lease or a first priority mortgage on movable assets which is not (1) used to make the country credit risks acceptable (*e.g.* for countries in high risk categories), or (2) mainly related to the buyer/borrower or the lessor risks.

Criteria:

- The assets are typically directly related to the transaction.
- The assets are identifiable and mobile or portable and can be physically as well as legally repossessed/seized by the creditor, its agent or nominee outside the country of the buyer/borrower or lessee.
- The security is irrevocable and unconditional for the entire duration of the credit.
- The assets have a prudently-assessed projected market value which corresponds throughout the repayment period to the amount of the outstanding debt.

- The security is registered offshore in an acceptable jurisdiction
- The assets can be freely sold and offer opportunities for their use outside the country of the buyer/borrower or lessee.
- The proceeds can be converted into the currency of the credit or in any other hard currency.
- In the event of realisation of the security, the proceeds are paid directly to the creditor.

Additional Factors to be Taken into Consideration:

The technique applies, in the first instance, to *e.g.* aircraft, ships and oil platforms, primarily intended to be used outside the country of the buyer/borrower or lessee, however it may be applied to all countries, buyers/borrowers and sectors, subject to a case-by-case consideration of the above characteristics and, *inter alia*, with regard to:

- The nature of the assets which may impact on their complete mobility, the possibility to repossess them outside the country of the buyer/borrower or lessee and their projected commercial market value.
- The costs of seizing, transporting, refurbishing and re-selling the assets, as well as the interest costs accruing until re-sale.
- The possibility of seizing the assets in the best-risk countries offering an appropriate legal environment.

Applicable MEF

The specific MEF to be applied shall:

- reflect the degree of potential country credit risk mitigation depending, *inter alia*, on the continuing value of the assets as well as the possible uncertainties with regard to their international recoverability;
- be determined on a case-by-case basis; and
- not exceed 0.10, or 0.20 in the case of aircraft.

In the case where the security (which should cover both Principal and Interest) is limited in amount on a uniform basis for the entire duration of the credit and for: (1) not less than 10 per cent of the Principal amount plus the related Interest, or (2) five million SDRs Principal plus the related Interest if the transaction exceeds 50 million SDRs, the MEF shall be calculated on a basis reflecting the amount of the security in comparison with the guaranteed Principal/the Principal amount of the credit.

5. Co-Financing with International Financial Institutions (IFIs)

Definition:

The export credit (*i.e.* insurance/guarantee/loan) is co-financed with an IFI which has been classified by the Participants for premium purposes.

Criteria:

- The IFI has a preferred creditor status.
- The IFI has assessed the project, its technical, economic and financial aspects and the country risk environment.
- The IFI is deemed to follow the execution and the repayment of the project.

Additional Factors to be Taken into Consideration:

The technique applies to all countries/buyers/borrowers and sectors where the IFI may intervene in accordance with its status and policy subject to a case-by-case consideration of the above characteristics and, *inter alia*, with regard to whether, in respect of the project:

- the Participant and the IFI have developed close exchanges during the evaluation and setting-up process of the project and of its financing;
- the Participant has obtained from the IFI the benefit of *pari passu* and cross-default clauses for the entire amount and duration of the credit;
- the clauses and the co-operation between the Participant and the IFI will also apply in case the maturity schedule of the two credits is not parallel; and
- the same IFI arrangements apply to any competing offer from a Participant.

Applicable MEF

The maximum applicable MEF shall be no greater than 0.05.

6. Local Currency Financing

Definition:

Contract and financing negotiated in convertible and available local, other than hard, currencies and financed locally that eliminates or mitigates the transfer risk. The primary debt obligation in local currency would, in principle, not be affected by the occurrence of the first two country credit risks.

Criteria:

- The ECA liability and claims payment or the payment to the Direct Lender are expressed/ made throughout in local currency.
- The ECA is normally not exposed to the transfer risk.
- In the normal course of events, there will be no requirement for local currency deposits to be converted into hard currency.
- The borrower's repayment in his own currency and in his own country is a valid discharge of the loan obligation.
- If a borrower's income is in local currency the borrower is protected against adverse exchange rate movements.
- Transfer regulations in the borrower's country should not affect the borrower's repayment obligations, which would remain in local currency.
- Subsequent to an event of default leading to a claims payment in local currency, the value of that claim is translated, as explicitly set out in the loan agreement, into an equivalent hard currency amount. Recovery of the claims payment would be in local currency as a counter value of the hard currency value of the claims payment at the time of the claims payment.
- Responsibility for conversion of local currency repayments by the buyer/borrower will be borne by the insured party who would also carry the exchange risk of devaluation or appreciation of local currency receipts. (Whilst a Direct Lender may have a direct exposure to currency fluctuations it is not related to country risks or buyer/borrower risks).

Additional Factors to be Taken into Consideration:

The technique applies on a selective basis in respect of convertible and transferable currencies, where the underlying economy is sound. The Participant ECA should be in a position to meet its obligations to pay claims expressed in its own currency in the event that the local currency becomes either 'non-transferable' or 'non-convertible' after the ECA takes on liability. (A Direct Lender would however carry this exposure.)

Translation of a defaulted amount (not the whole loan value) into an equivalent hard currency amount would still leave the borrower with a continuing local currency obligation, albeit of an 'open-ended' value, in relation to the equivalent hard currency value of the defaulted amount. The eventual payment in local currency by the borrower of its outstanding indebtedness would need to be equivalent to the hard currency value of the claims payment at the time of the claims payment.

Applicable MEF

The specific MEF to be applied shall be determined case-by-case basis, however, if the first three country credit risks are specifically excluded, the maximum MEF is 0.50. If the risk is only mitigated, *i.e.* not explicitly excluded, the maximum MEF is 0.35.

7. *Third Country Insurance or Conditional Guarantee*

8. *Debtor Representing a Better Risk than the Sovereign*

The use of techniques 7 and 8 of this Annex is subject to further discussions among the Participants.