OECD extends risk scale for corporates and banks

JIMMY CROALL EXPLAINS THE NEW RISK-GRADUATED SCALES OF MINIMUM PREMIUM RATES FOR CORPORATE AND BANK RISK.

A 1978 OECD agreement controls how official export credit agencies (ECAs) in member countries can support export credits with a repayment term of two years or more. The agreement seeks to foster a level playing field so that competition among exporters is based on the quality and price of the goods and services being exported rather than the most favourable officially supported financing. The agreement therefore specifies such terms as the minimum level of payments to be made by delivery and maximum credit periods. There are separate sector understandings for civil aircraft, ships, nuclear power plant, renewable energies and water projects.

Under the agreement, ECAs have to charge a premium to cover the risk of non-repayment of credits. There is a specific requirement that those rates be "risk-based, shall converge and shall not be inadequate to cover long-term operating costs and losses".

Since 1998 minimum premium rates have also been stipulated for country and sovereign risk. All except "category zero" countries (high income OECD and euro zone nations) are classified according to seven risk categories (reviewed at least annually), each of which attracts its own scale of minimum premium rates.

The OECD minimum rates for a transaction vary not just by reference to the categorisation of risk but also by the length of the credit period and indeed the quality of the cover being provided by the ECA (unconditional guarantees, for example, attract higher premium rates than conditional insurance cover). Member ECAs are required to charge no less than these minima irrespective of whether the buyer is a private or public entity. For category zero countries ECAs are required, case by case, to ensure that the premiums they charge do not undercut available market pricing.

In recent years a growing proportion of ECA-supported credit business has been to non-sovereign buyers, so the absence of any OECD minimum premium rates specific to corporate and bank risks has been a shortcoming of the 1998 regime. And banks and corporates domiciled in a good sovereign are not necessarily good risks themselves. The resulting scope for significant variation in the premiums charged by ECAs for non-sovereign business has therefore provided a driver for OECD members to work towards an extension of the minimum premium rate structure to include rates appropriate to corporate and bank risk. The aim is to deliver a more level playing field and meet the requirement that premiums should be risk-based and converge.

Table 1: OECD Sovereign Risk Categories

		OECD Sovereign Risk Category						
		1	2	3	4	5	6	7
OECD Corporate Risk Category	BTS	Better than Sovereign (BTS) requires the obligor to have a foreign currency rating better than the host sovereign from an accredited credit ratings agency, and provides a 10% discount on the minimum sovereign premium rate.						
	SOV/CC0	Sovereign/CC0 is for sovereigns and for banks and corporates that carry the same credit rating as the host sovereign, and are therefore subject to the same minimum premium rate.						
	CC1	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB	BB-	B+	B
	CC2	A+ to A-	BBB+ to BBB-	BB+ to BB	BB-	B+	B	B- or worse
	CC3	BBB+ to BBB-	BB+ to BB	BB-	B+	B	B- or worse	N/A
	CC4	BB+ to BB	BB-	B+	B	B- or worse	N/A	N/A
	CC5	BB- or worse	B+ or worse	B or worse	B- or worse	N/A	N/A	N/A

Accordingly, following two years of intensive negotiation the OECD members agreed a new regime of the premium rules early last year. The effect of the changes (which will be implemented from 1 September 2011 following a lengthy transition period) is to:

- reduce the existing scale of minimum premium rates for sovereign/country risk by up to 10%; and
- introduce risk-graduated scales of minimum premium rates for transactions involving public, corporate and bank buyers/obligors.

Table 1 shows the possible combinations of country and corporate under the new rules and the concordance that the OECD has made between the corporate buyer categories and agency-style ratings.

The new minimum premium rates vary not only on the basis of the country and buyer classification but also the horizon of risk and the quality of the cover being provided by the ECA. For example, Table 2 details the new minimum rates for a credit transaction with a horizon of risk of 5.5 years, 95% of cover for a "standard" product.

These rates are payable on the principal value of the credit. Where the ECA is an export bank and the official support is provided by means of direct credits or financing, the OECD agreement provides for the premium to be added either to the face value of the interest or to be recouped as a separate charge. Otherwise premium is generally recouped up front, whether directly from the insured or as a first drawing from the guaranteed loan.

To assist member ECAs in classifying buyers according to the established categories, the OECD has provided qualitative descriptions of each buyer risk category (SOV+ to CC5). An obligor obtains the SOV+ classification only if its foreign currency rating is better than that of its respective sovereign. It is possible under the new rules to obtain some reduction in these rates where risk mitigation is provided in the form of an offshore escrow account or local currency financing.

Under the new regime more guidance is provided for ECAs on the pricing of business in category zero countries to help avoid undercutting available market pricing. Specifically, the following benchmarks of market pricing are identified:

- private market pricing of the uncovered portion of the export credit transaction;
- pricing of corporate bonds in respect of the name-specific credit risk;
- name-specific credit default swaps or, failing that, indexed credit default swaps (eg. for the industry sector in question);
- loan benchmarks for the obligor or, failing that, for obligors comparable in terms of ratings and transactions with comparable tenors;
- benchmark market curves reflecting the credit risk of a whole sector or class of buyers; and
- weighted average cost of financing resources if this can be calculated from the obligor's financial statements.

In the absence of such benchmarks for a prospective category zero transaction, or for smaller transactions in general, the new agreement envisages recourse being made to the corresponding premium rate for country category 1.

Improved though this guidance is, the remit not to undercut market pricing in category zero continues to depend essentially on "best endeavours". This is certainly so by comparison with the new regime of minimum premium rates for civil aircraft introduced in February 2011 where the minima are updated quarterly by reference to movements in Moody's median credit spreads, thereby assuring a degree of read across to market pricing.

Table 2: Example: Rates for credit transaction, 5.5-year tenor, 95% cover

Premium rates		OECD Sovereign Risk Category						
		1	2	3	4	5	6	7
Current minimum		0.90	1.59	2.56	3.72	5.09	6.43	7.96
New Minimum	BTS/SOV+	0.76	1.31	2.05	3.04	4.34	5.54	7.07
	CC0/SOV	0.85	1.45	2.28	3.38	4.82	6.15	7.85
	CC1	1.45	2.11	2.88	3.93	5.37	6.70	8.54
	CC2	1.95	2.62	3.50	4.66	6.17	7.57	9.34
	CC3	2.33	3.21	4.04	5.30	6.91	8.79	
	CC4	3.07	3.97	5.00	6.35	8.24		
	CC5	4.31	5.16	6.24	7.83			

THE AIM IS TO DELIVER A MORE LEVEL PLAYING FIELD AND MEET THE REQUIREMENT THAT PREMIUMS SHOULD BE RISK-BASED AND CONVERGE.

The new OECD rates do not apply to aerospace or ships, which are governed by separate sector understandings. Likewise, as the agreement applies to transactions with a repayment term of two years or more, the new minimum rates do not apply to business covered under ECGD's cash export insurance policy or new products such as the letter of credit guarantee or contract bond support schemes.

The new rules will apply to all new ECA commitments made from 1 September 2011. Any transactions with premium commitments issued before that date must be finalised by 31 March 2012.

The new regime of minimum premium rates is the result of lengthy negotiation and compromises were required on all sides to reach an agreement. ECGD would have preferred more granularity, particular when looking at higher risk credits (eg. CC5 in country category 1 affords just a single minimum rate for all corporates rated BB- or below).

Even so, we believe that by extending the regime of minimum premium rates to include risk-graduated scales of minimum premium rates for corporate and bank risk, the OECD has taken a major step forward in its efforts to create a more level playing field and greater convergence. The regime does not apply to non-OECD member ECAs.

Jimmy Croall is deputy director for pricing at ECGD.
Jimmy.croall@ecgd.gsi.gov.uk
www.ecgd.gov.uk

Fuller details of the changes to the rules on minimum premium rates can be found at ***http://bit.ly/ooytLI***
Details of OECD country risk classifications as at 1 July can be found at ***http://bit.ly/opjLJy***