

Ch. III Core Business Policies and Practices

Section A: Cover Policy and Risk-Taking

INTRODUCTION

Cover policy refers to an ECA's willingness to provide protection against commercial and political risks in a particular market. ECAs' cover policies and risk-taking practices significantly impact an exporter's ability to effectively compete for sales. Cover policy decisions are based on an ECA's underwriting approach and its consideration of whether and how to place limits, in terms of risk type or volume, on the business it can support. Limits on transaction size, repayment terms or total commitments per country are the methods many ECAs use to control the flow of new business.

An ECA's approach to non-sovereign risk is another important aspect of cover policy. Exporters whose ECA is willing to take on new business with entities other than sovereign governments or first class private institutions can enter markets and gain competitive advantages over foreign competitors. While most ECAs have historically covered sovereign, public and major bank business, increasing privatization in the developing world has presented ECAs with increasing requests to cover private risks, ranging from large corporations to small businesses. The scope and depth of an ECA's willingness to cover private sector risk, especially of small private entities, has become a more critical competitive aspect of an ECA's cover policy.

EX-IM BANK'S COUNTRY COVER POLICY AND PRACTICE

When open in a market for a given term, Ex-Im Bank is less risk averse than other ECAs in its willingness to extend credit to buyers, including smaller, private entities. In addition, U.S. exporters and banks benefit from the absence of country and sector ceilings on Ex-Im Bank's cover policy.

U.S. exporters realize these advantages because Ex-Im Bank takes a different approach to country cover policy than most ECAs. The goal for Ex-Im Bank is to provide financing for creditworthy export transactions, regardless of destination, when there is foreign ECA-supported competition or when private sector financing is unavailable. In other words, restrictions on the provision of Ex-Im Bank cover in a given market pertain to the creditworthiness issues of a transaction, as opposed to portfolio controls. Ex-Im Bank will typically support transactions without size or country limits as long as there is a reasonable assurance of repayment (and additionality) in each transaction. One exception is when Ex-Im Bank is statutorily prohibited from doing business in a particular market, generally as a result of sanctions.

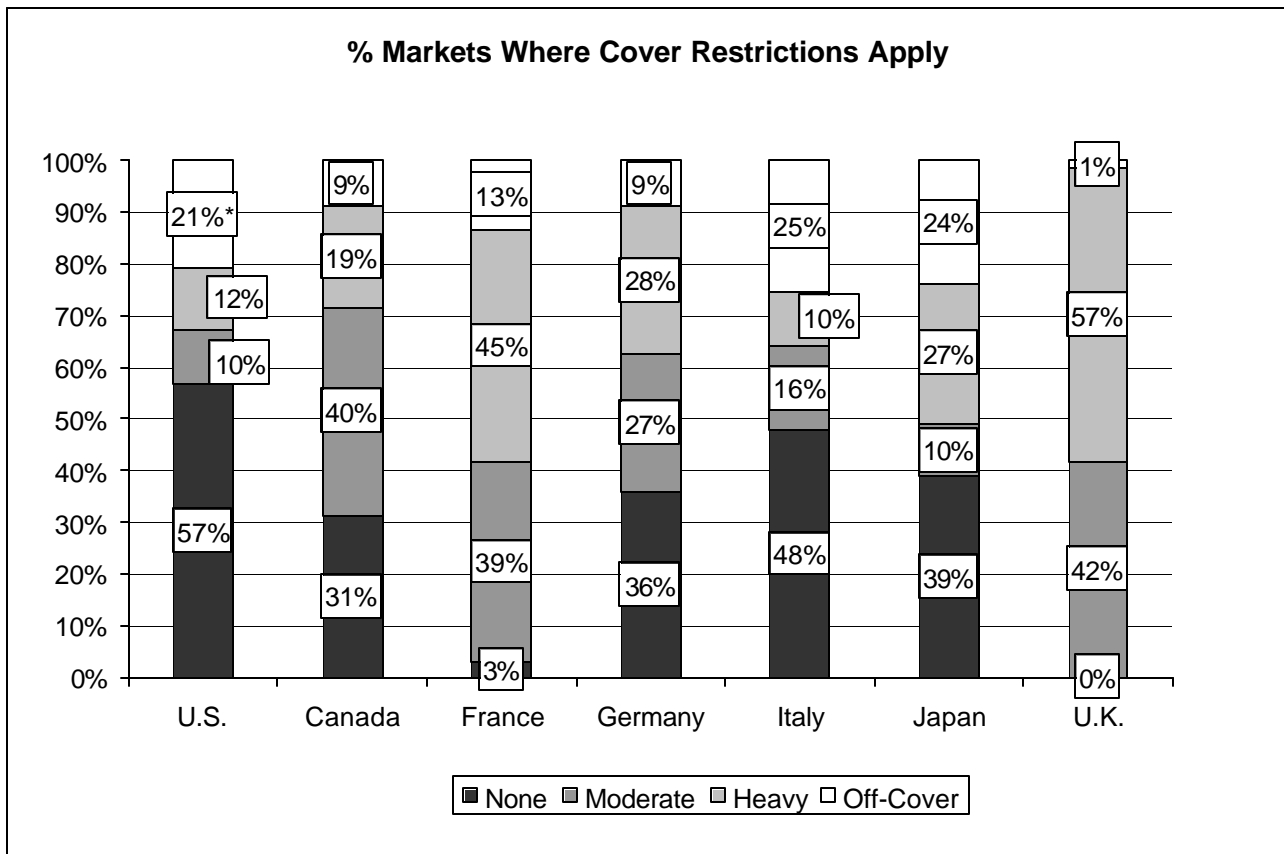
With respect to risk-taking practices, Ex-Im Bank shows a willingness to cover the risk of smaller, private entities and seeks to minimize the requirement for bank guarantees and other forms of security in order to reduce the associated costs of these guarantees to U.S. exporters.

G-7 ECAs' COVER POLICIES AND PRACTICES

Other G-7 ECAs are willing to take on sovereign government risk; however, with respect to private sector transactions, these ECAs tend to be risk averse. They control their risk appetite for private sector business by, for example, imposing country and/or sector exposure limits. In addition, they prefer to focus on well-known or rated entities (which are usually banks) or rely (by requiring risk-sharing of 5%-20%) on the due diligence and underwriting approaches of the banks they cover. The other G-7 ECAs are also facing new challenges with underwriting an increasing demand for cover of private sector risk in emerging markets undergoing privatization efforts.

SUMMARY DATA

Figure 3: Comparison of Medium- and Long-Term ECA Country Cover Policy



*In 6% of the 67 markets, Ex-Im Bank was closed due to legislative sanctions.

Figure 3 shows the overall openness of the G-7 ECAs by comparing cover policy in 2002 for a sample of 67 major ECA markets. As illustrated, there is a difference in approach to overall cover policy and the degree to which ECAs are willing to assume unsecured risks. Specifically, Ex-Im Bank is open in more markets than any of the other G-7 ECAs. Further, relative to its major competitors, Ex-Im Bank generally imposes far fewer restrictions on the provision of cover than other ECAs. Ex-Im Bank is off cover in 21% of the 67 markets; however, Ex-Im Bank was closed for business in 6% of the sample markets due to legislative reasons.

With respect to ECAs' risk-taking practices, **Figure 4** provides a broad characterization of the G-7 ECAs' risk appetite for business with less well-known private entities, as opposed to large corporations or bank guaranteed borrowers.

Figure 4: ECA Risk-Taking Practices

Taking Credit Risk of Smaller, Less Well-Known Private Entities in a Market:				
Never----->Infrequent----->Frequent----->				
NEXI and JBIC (Japan)	ECGD (U.K.)	SACE (Italy), Coface (France), Hermes (Germany)	EDC (Canada)	Ex-Im Bank

Most G-7 ECAs continue to prefer to offer support to well-known or rated entities or rely on risk-sharing to minimize exposure to smaller, private entities. Conversely, Ex-Im Bank is more comfortable taking the risk of smaller, less well-known private entities than competitor ECAs and does not follow other ECAs in their risk-sharing practices.

EXPORTER AND BANKER VIEWS

Banks and exporters were asked to comment on the competitiveness of Ex-Im Bank's country cover policy and risk-taking practices vis-à-vis its competitors. Respondents agreed that "Ex-Im Bank is ahead of the game in risk-taking practices [and] it's the best ...in communicating what risks it will take." One bank noted that Ex-Im Bank is "more willing to do sub-sovereign and corporate risk" than other ECAs. In addition, an exporter stated that "Ex-Im is the best [and it] should protect and maintain its cover policy." On the other hand, exporters noted that legislative sanctions have an adverse impact on their access to markets where there is other officially supported ECA competition.

CONCLUSION

Ex-Im Bank continues to be generally competitive in its cover policy and risk-taking practices. Once Ex-Im Bank is open in a market for a given repayment term, U.S. exporters and banks benefit from the lack of country and sector ceilings that other ECAs place on their cover policies. The one exception to this rule is in the few markets where Ex-Im Bank is statutorily closed yet other ECAs are open. Additionally, Ex-Im Bank is less risk averse in its willingness to extend credit to smaller private entities.

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Section B: Interest Rates

INTRODUCTION

A key component of the competitiveness of an export finance package is the interest rate that the buyer is charged. Accordingly, early in the life of the OECD Arrangement on Guidelines for Officially Supported Export Credits, member countries established a minimum interest rate to be charged when a member ECA is lending to the buyer (either directly or by providing funding support to a lender). The minimum interest rate, referred to as the Commercial Interest Reference Rate (CIRR), is a fixed, market-related rate that is calculated using the government's fixed rate borrowing costs plus a fixed spread of 100 basis points. The OECD Arrangement contains procedures for offering, setting and holding the CIRR for official lending. Over the past several years, officially supported fixed interest rates have been of declining importance to overall competitiveness, with only 35% of ECA long-term financing support in 2002 offered using official fixed interest rates (including both direct lending and interest make-up systems), as compared to 53% in 1997.

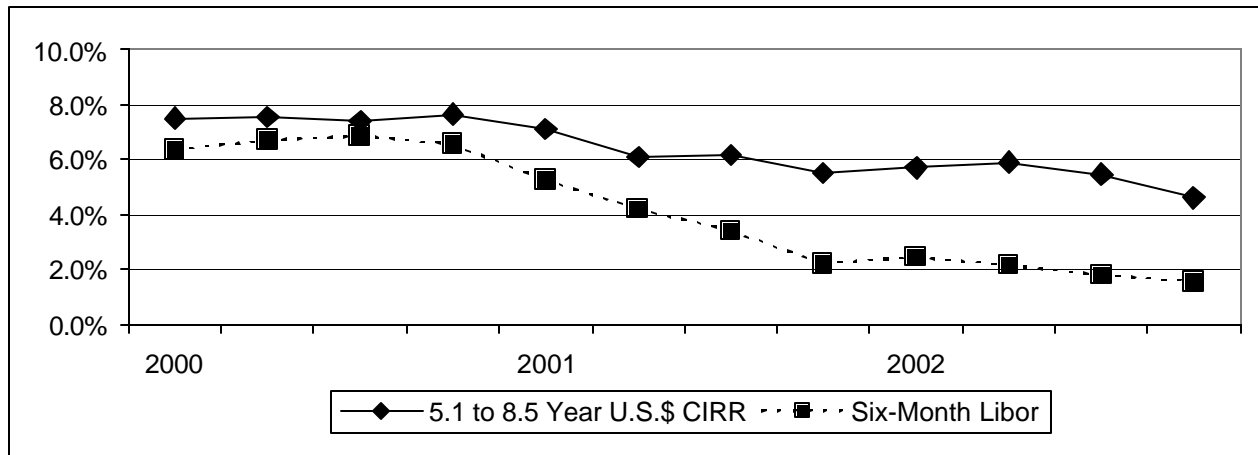
EX-IM BANK'S POLICY AND PRACTICE

Ex-Im Bank provides official support through both a direct lending product and two pure cover² (guarantee and insurance) products. The interest rate for direct lending is set using the CIRR procedures detailed in the OECD Arrangement. Monthly, Ex-Im Bank calculates the U.S. dollar CIRR for three different repayment term scenarios (up to five years, over five to eight and a half years, and over eight and a half years) and uses the current rate (or a previously offered rate that meets the "holding" procedures defined in the OECD Arrangement) to set the interest rate for any direct loans authorized during the month. This interest rate then becomes the fixed interest rate for the life of the transaction, including the construction, drawdown and repayment periods. Because a floating rate CIRR has not been established in the OECD Arrangement, Ex-Im Bank only lends at a fixed interest rate.

For pure cover interest rates, the rate is set by the lender, not by Ex-Im Bank or by reference to the OECD Arrangement. Under pure cover, the interest rate may be either fixed or floating, and it may contain the flexibility to switch from a pure cover floating rate to a pure cover fixed rate at the lender's and buyer's discretion. Generally, a floating rate pure cover interest rate will be based on LIBOR and have a spread in the range of 0 to 100 basis points (for larger transactions) or 20 to 400 basis points (for smaller transactions).

² Definition: official support that covers private bank lending and does not involve the provision of interest rate funding support by the ECA.

Figure 5: Comparison of CIRR and LIBOR Interest Rates



Buyers tend to prefer using Ex-Im Bank's pure cover products because of the greater level of flexibility in the products and (thanks to the generally declining interest rates over the past decade) the lower interest rates that can currently be achieved on a floating basis (see **Figure 5**). Reflecting this tendency, in 2002 less than 3% of the more than \$8 billion authorized under the medium- and long-term programs was for direct loans.

G-7 ECA'S POLICIES AND PRACTICES

Generally, Ex-Im Bank's competitors offer similar products: direct loans, insurance and guarantees (see **Figure 6**). While only Ex-Im Bank offers all three products, five of the six other G-7 ECAs have a mechanism for offering both CIRR rates and pure cover, and all but Germany regularly offer official fixed rate support. However, three of the five do so through banks, using an interest make-up program (IMU). IMU is a means by which governments compensate commercial banks that provide fixed rate export finance at CIRR but fund the cost of loans at floating rates. The commercial bank receives an agreed rate of return based on the floating cost of funds plus an agreed margin. If this return proves to be higher than the fixed rate CIRR, the commercial bank receives the difference between the fixed rate and the floating rate (plus the margin). If the floating rate is lower than the fixed rate, the commercial bank pays to the ECA the difference between the floating rate and the fixed rate (less the margin).

Figure 6: ECA Product Offerings

	Loan	Guarantee	Insurance	IMU
Canada	X	*	X	
France		**	X	X
Germany	X	**	X	
Italy			X	X
Japan	X		X	
United Kingdom		X		X
United States	X	X	X	

* In response to Canadian bank complaints, Canada has recently begun to offer, on a limited basis, a guarantee program.

** Both France and Germany will offer a guarantee for Airbus aircraft transactions.

The CIRR regime represents a common set of rules that should not yield an inherent advantage or disadvantage for any particular country. However, there is the potential for a certain degree of subsidization (either of the administrative costs of banks offering export finance loans or of the interest rate charged on the portion of the financing not covered by official financing support) via IMU schemes. See **Figure 7** below for a comparison of indicative returns to banks under CIRR and IMU.

Under most IMU systems, the floating rate base rate of LIBOR or EURIBOR is used. The spreads range from about 40 to 90 basis points. There are no agreed rules on the level of spreads that governments may offer their banks to provide CIRR loans. The rationale for the level of margin and the purposes for which the margin is intended vary from country to country. Generally, IMU support is offered to cover administrative costs. In some programs, the IMU margin is used to provide a pure profit margin or to cover liquidity costs. The coverage of credit risk is also a major use of IMU margins, including the risks associated with the portion of the financing package that is not covered by the official financing support, i.e., the risk of the 5% portion that the bank must cover. In any case, use of the IMU system has a competitive component to it as the profitability can induce better (or more) “side” financing or terms on the core financing.

On pure cover transactions, the interest rates charged when support is provided by one of the other G-7 ECAs are generally higher than those charged when Ex-Im Bank is providing guarantee support. Banks lending under Ex-Im Bank’s guarantee take no risk on the guaranteed portion due to the fact that the guarantee is a 100% comprehensive unconditional guarantee. In contrast, most other ECAs offering pure cover only offer 95% conditional insurance cover. Under a conditional insurance policy, the commercial bank faces documentary risk, i.e., the validity of a claim will not be determined until the claim is filed. In addition, the commercial bank is exposed to credit risk when the ECA cover is less than 100%. Faced with such risks, most lenders add additional spread over any standard return requirement on official export credits. For instance, spreads on European insurance cover are generally in line with their IMU

spreads, varying between 45 and 90 basis points but averaging closer to 70 to 80 basis points. See **Figure 7** below for a comparison of indicative returns to banks under 100% and 95% cover.

SUMMARY DATA

Figure 7: Indicative Pricing of ECA Supported Export Credit Deals

	Cost of Funds	Interest Rate Charged	Margin to Commercial Bank
Fixed Rates:			
CIRR*	N/A	4.05%	N/A
IMU	Libor	4.05%	75 bp
Floating Rates:			
100% Pure	Libor	Libor + 20 bp	20 bp
95% Pure	Libor	Libor + 62.5 bp	62.5 bp

*5.1 to 8.5 year CIRR as of December 31, 2002

EXPORTER AND BANKER VIEWS

Banks and exporters commented in greater depth this year, as opposed to previous years, on the competitiveness of interest rates associated with Ex-Im Bank financing. From the banks' and exporters' points of view, the CIRR rates offered by Ex-Im Bank are competitive with the CIRRs offered by other ECAs. However, several banks raised concerns about the competitive impact of interest rate make-up systems and how such systems provide excess fee income to the European banks, which may be used to cross-subsidize the uncovered cash payment portion. On pure cover interest rates, the majority of both exporters and banks indicated that interest rates under the Ex-Im Bank guarantee were more competitive in comparison to rates supported by other ECAs.

CONCLUSION

Overall, the extent and depth of ECA competition in the basic area of official interest rates has been gradually declining for nearly two decades. However, differences in the application of that system offer the possibility of some ECAs gaining modest advantages in select transactions.

The use of IMU schemes by Ex-Im Bank's competitors puts Ex-Im Bank at a slight disadvantage on officially financed cases, as IMU can be used to lower the all-in cost of a financing package. On the other hand, Ex-Im Bank has a competitive advantage on pure cover cases with the low interest rates generated under its 100% guarantee cover. The net result is that Ex-Im Bank is generally equivalent to other G-7 ECAs in its ability to support competitive interest rates.

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Section C: Risk Premia

INTRODUCTION

ECAs charge exposure fees for taking the repayment risk of the borrower. Although many factors influence the all-in cost of an officially supported export transaction, the exposure fee, or risk premia, can constitute a considerable amount of the direct financing costs. In 1999, the OECD adopted the Knaepen Package, an exposure fee agreement that defined the elements for the determination of sovereign fees, including the establishment of the principle of minimum premium benchmarks (MPB) for sovereign risk transactions, below which, with some specific exceptions, ECAs may not charge.

The sovereign risk minimum premium formula is based on the following factors: (1) the percentage of cover (100% vs. 95%); (2) the quality of the product (unconditional guarantee vs. conditional insurance); and (3) the claims payment policy. The latter two factors determine whether a product is considered “above standard”, “standard” or “below standard.” For example, standard products include direct loans and insurance with no claims waiting period, whereas unconditional guarantees are considered above standard. The formula works such that above standard products are the most expensive, and below standard products are the least expensive. Beyond the MPB, the system allows each ECA to use its own fee system to determine whether additional surcharges need to be applied to sovereign transactions. Hence, a common floor exists, but ECAs may add a surcharge to the MPB according to their risk assessment process.

With regard to non-sovereign risk premia, ECAs may not charge less than the sovereign MPB in a given market. However, beyond that one stipulation, ECAs are free to charge any or no additional surcharge for a non-sovereign transaction. Consequently, exposure fees for non-sovereign risks can vary.

EX-IM BANK'S POLICY AND PRACTICE

Regarding sovereign risk premia, Ex-Im Bank's guarantee product is considered to be above standard due to its unconditional cover – the best coverage available. As a result, all other factors being equal, the minimum premium benchmark on an Ex-Im Bank guarantee would be nominally higher than the MPB charged by a competitor ECA that offers a standard product. Nevertheless, the all-in cost of all levels of MPBs is equivalent for pure cover transactions. That is, the lower MPB on standard products is paired with a higher spread over LIBOR, whereas the higher MPBs on above standard products is coupled with lower spreads.

For non-sovereign premia, Ex-Im Bank assesses risk by looking at the non-sovereign borrower's risk compared to the sovereign's credit risk. If the non-sovereign borrower, whether it is a bank or public or private entity, is viewed as having a similar or better repayment risk compared to the sovereign, the exposure fee charged would be the same as for the sovereign (i.e., the minimum

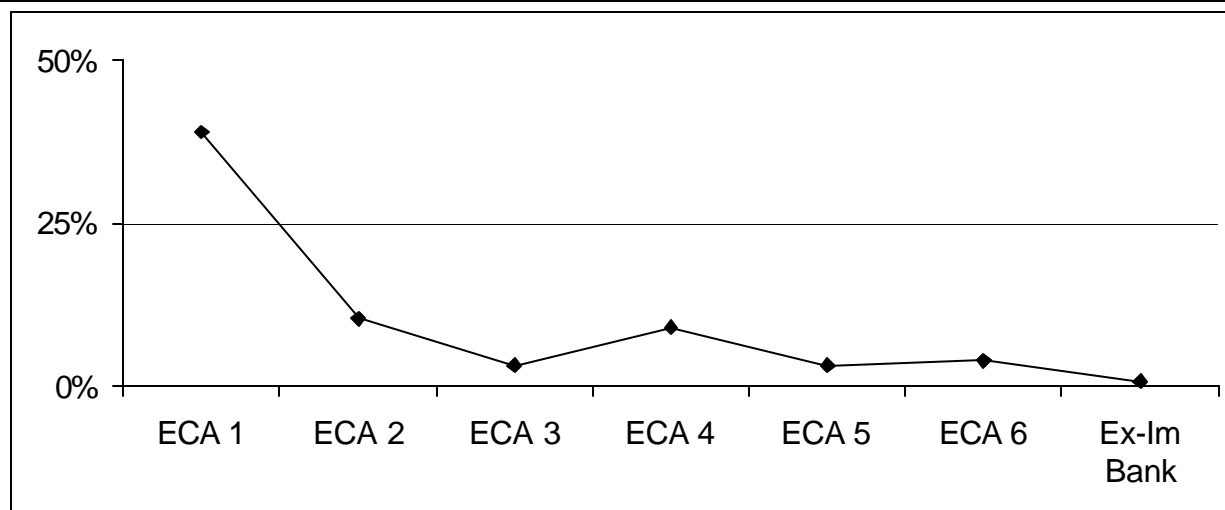
premium benchmark). On the other hand, if the risk is deemed to be higher, then incremental surcharges are added to the minimum exposure fees. Ex-Im Bank's non-sovereign fees tend to be relatively less expensive than those charged by our major counterparts (see below).

G-7 ECAs' POLICIES AND PRACTICES

While the Knaepen Package sets the floor for all sovereign and non-sovereign transactions at the MPB for sovereign risk, ECAs may use their own systems to determine if and under what circumstances surcharges are added. Generally, the insurer ECAs of Europe tend to add specific surcharges depending on the type of the borrower risk. For sovereign risk, most of the G-7 ECAs also add a modest incremental surcharge on many cases. For non-sovereign risk, the typical approach of European ECAs is based on categories of risk as opposed to specific buyer risk. For example, a first-rate bank would be charged the sovereign fee plus a surcharge based on its status as a commercial bank, while a private buyer would be charged the sovereign fee plus a higher surcharge based on its status as a private non-financial entity. On the other hand, Ex-Im Bank and most non-European ECAs price on a transactional basis, assessing a non-sovereign borrower's repayment risk case-by-case.

Figures 8 and 9 compare average exposure fee surcharges for the G-7 ECAs with Ex-Im Bank's pricing practices for sovereign and non-sovereign transactions respectively. As seen below, on average, Ex-Im Bank and most other ECAs charge exposure fees at or slightly above the minimum premium rate allowable for sovereign risk transactions. In addition, most ECAs impose surcharges for non-sovereign risk transactions. Some ECAs do so on a category basis while others use a risk-assessment basis.

Figure 8: Average MPB Surcharges on Sovereign Risk Transactions*



*2002 preliminary data

Figure 9: Sample MPB Surcharges on Non-Sovereign Risk Transactions

Sample Market	ECA	Surcharge
Brazil	ECA 1	87.0%
	ECA 3	25.0%
	ECA 4	17.5%
	ECA 6	9.2%
	ECA 2	2.2%
	Ex-Im Bank	0.7%
	ECA 5	0%
Philippines	ECA 1	157.2%
	ECA 3	30.0%
	ECA 6	26.2%
	ECA 4	15.5%
	ECA 2	14.6%
	Ex-Im Bank	10.5%
	ECA 5	0%

EXPORTER AND BANKER VIEWS

Banks and exporters were asked to provide feedback on the competitiveness of Ex-Im Bank's exposure fees, and most respondents agreed that Ex-Im Bank is competitive vis-à-vis competitor ECAs with respect to transaction pricing. Banks specifically stated that "recent OECD harmonization rules appear to have reduced the major pricing differentials" and that "exposure fees are competitive."

CONCLUSION

The Knaepen Package placed a sovereign-based floor on exposure fees, which creates a level playing field with respect to minimum exposure fees charged. While non-sovereign transactions must meet the same minimum sovereign rates, there can be significant differences in the surcharges ECAs impose. Ex-Im Bank offers very competitive exposure fees vis-à-vis the G-7 ECAs for both sovereign and non-sovereign risks.

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Section D: Ex-Im Bank's Core Competitiveness

Both collectively and independently, Ex-Im Bank's core financing elements are considered to be generally competitive with (and in many cases, more competitive than) those offered by our G-7 ECA counterparts. Evaluated on a global basis across all programs, Ex-Im Bank's core financing elements fall just short of an A+, or fully competitive. In fact, of the 65%-85% of transactions where CIRR is not relevant, the all-in cost associated with Ex-Im Bank's medium- and long-term financing is typically lower than the all-in cost of the other G-7 ECAs most of the time.

Figure 10: Grading of Ex-Im Bank's Core Competitiveness

Key Elements	Grade
Cover Policy	A
Scope of country risk	A
Depth of non-sovereign risk	A+
Breadth of availability (e.g., restrictions)	A
Interest Rates	A
CIRR	A-
Pure cover	A+
Risk Premia	A+
Sovereign	A
Non-Sovereign	A+
Total Average Grade	A

