Chapter 3: Core Business Policies and Practices
Section B: Interest Rates

Introduction

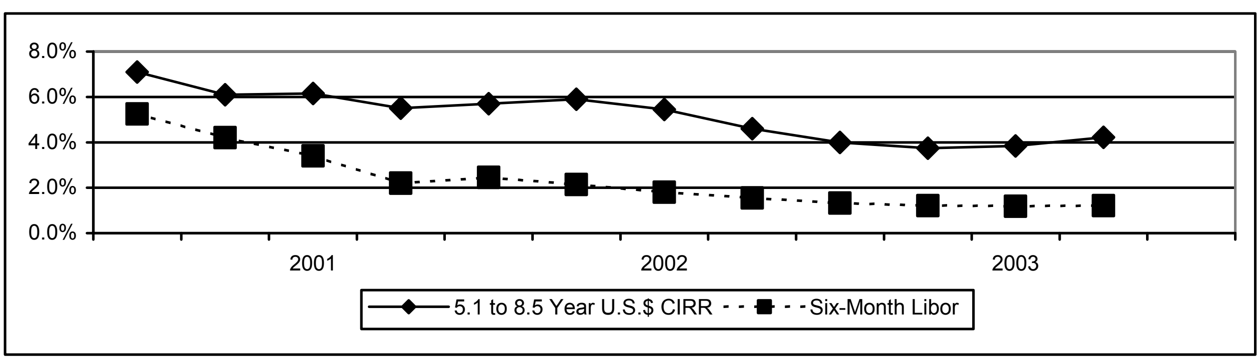
The interest rate charged to a buyer is a central component of an export finance contract's competitiveness. Accordingly, the OECD Arrangement sets minimum interest rates for export transactions that receive official financing support (e.g., direct loans from an ECA) in order to eliminate the use of concessional interest rates as a competitive factor. These minimum interest rates, or Commercial Interest Reference Rates (CIRRs), are fixed, market-related rates that are calculated using a government's fixed rate borrowing costs plus a fixed spread of 100 basis points.

Over the past several years, officially supported fixed interest rates have been of declining importance to overall competitiveness. In 2002, only 34% of ECA long-term financing support used official fixed interest rates (including both direct lending and interest make-up systems) as compared to 53% in 1997 (2003 data is not yet available). This decline is most likely attributable to the lower floating rates achieved in the commercial market as compared to the fixed CIRR. In a rising interest rate environment, however, fixed rates could become more attractive.

Ex-Im Bank's Policy and Practice

Ex-Im Bank provides fixed-rate official financing support through its direct lending program and sets the interest rate using the CIRR procedures detailed in the OECD Arrangement. In fiscal year 2003, less than 1% of the $7.7 billion authorized under the medium- and long-term programs were direct loans. Interest rates for transactions under Ex-Im Bank's guarantee and insurance programs are set by the lender, not by Ex-Im Bank or by reference to the OECD Arrangement. Buyers tend to prefer using Ex-Im Bank's guarantee and insurance products because of their flexibility and the lower interest rates that can currently be achieved on a floating rate basis (see **Figure 5**).

Figure 5: Comparison of CIRR and LIBOR Interest Rates



G-7 ECAs' Policies and Practices

CIRR support is available under the programs of Ex-Im Bank's competitors. However, not all G-7 ECAs offer CIRR support through direct lending. While Canada, Japan and, very infrequently, Germany offer CIRR support for direct credits the other three – France, Italy and the UK – offer CIRR support through banks, using an interest make-up program (IMU). Under an IMU program, when commercial banks provide direct loans at CIRR rates to borrowers, they are guaranteed a return equal to the cost of borrowed funds plus a margin. Thus, if needed, ECAs "make up" the difference between the agreed return and the CIRR rate. For example, if this return is higher than the fixed rate CIRR, the commercial bank receives a payment from the ECA worth the difference. Alternatively, if the cost of funds plus the margin is less than the CIRR rate, the commercial bank pays the ECA the difference.

Under most IMU systems, the floating 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, and 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, but under some programs, the IMU spread is used to provide a pure profit margin to the commercial lender or to cover its 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. The use of the IMU system has a competitive component to it as the profitability to a private lender can induce more financing either in the form of "side" financing[2] or better terms on the core financing.

For other G-7 ECAs' guarantee and insurance transactions, the interest rates charged 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; hence, no incremental "risk premia" is required to compensate for the bank's risk. 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 an 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.

[2] Side financing refers to the portion of the contract that is not covered under the official financing package e.g., the down payment.

Exporter and Lender Survey Results

Based on the survey and the focus group findings, the exporting community primarily used the insurance and guarantee programs. They found that the interest rates generated by these two programs were generally competitive. Only one participant noted that the European IMU programs could be slightly more advantageous, but this was not cited as a reason for lost sales in 2003.

Conclusion

Competition between ECAs based on interest rates has been tame for the past several years. While the Bank's 100% unconditional guarantee program generates very favorable interest rates in comparison to the 95% conditional insurance offered by many other ECAs, European ECAs' IMU programs offer spreads to commercial banks that could represent a competitive disadvantage to Ex-Im Bank. Nonetheless, neither of these programs significantly impacts competitiveness, and Ex-Im Bank in 2003 remained generally competitive with its G-7 counterparts.