PREMIUM: THE LEAST UNDERSTOOD RULES OF THE ARRANGEMENT

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The low-hanging fruits always get picked first – and if one is lucky – somebody else will climb the ladder later to finish the job for you.

By the time I arrived on the OECD export credit scene in 1994, the low-hanging export credit fruit (relatively straightforward albeit politically sensitive disciplines on *e.g.* maximum repayment term, minimum interest rates) had indeed already been "selected, and a group of unlucky "experts" (including myself) were asked to pick up the ladder and come up with rules to address a complicated issue that had eluded all previous rule-making attempts – premium for credit risk. In 1997, we succeeded in reaching agreement on rules for minimum credit risk premium rates (the so-called Knaepen Package) that took the form of country-specific floor rates; these rules were incorporated in the Arrangement on Officially Supported Export Credits. As such, the rules for minimum premium rates (MPRs) did not directly address the component of credit risk attributable to the borrower's creditworthiness (commercial risk), which in many cases accounts for the lion's share of the risk of non-repayment.

Later, in 1999, just as the rules of the Knaepen Package came into force, I joined the OECD's export credit secretariat; in this new capacity I was asked to "hold the ladder" for those brave enough to try and secure what had looked to be completely out of reach at the end of the Knaepen Package negotiations; comprehensive rules addressing the full credit risk spectrum, including commercial risk.

Others have written about this topic and much of what needs to be explained has been explained. Pierre Knaepen (Belgium), the first Chairman of the Premium Experts Group – which was set up by the Participants to the Arrangement – provided a detailed account in the export credit publication "*The Export Credit Arrangement, Achievements and Challenges 1978-1998* (produced in connection with the 25th anniversary of the Arrangement) of the first round of negotiations that led to the 1997 Knaepen Package. David Drysdale (the third and current Chairman of the Premium Experts Group) writes in this publication on the ensuing negotiations (which started under the Chairmanship of Detlev Malzkuhn of Germany) that eventually led to the 2010 Malzkuhn-Drysdale Package.

In their articles, both Pierre and David have explained the wider context against which the premium rules were developed and the motivations behind establishing such rules, so I do not think that it is necessary to cover this ground again. My intention in writing this article is rather to provide a broader picture of why the rules turned out as they did and their practical impact on those who make use of official export credits – using plain English, but I make no promises here!

What's the big deal about premium and why are rules needed anyway?

A likely response to any "what's the big deal about" question is, of course, money. And when it comes to official export credits, the premium rate charged by an export credit agency (ECA) more often than not is the largest component in the overall price of financing and, consequently, a significant factor in the total cost of an export that is passed on to an overseas buyer. Thus, a high premium rate has the potential to make a transaction economically non-viable, whereas a very low premium rate can transform a losing export contract bid into a winner. Of course in practice, an institution that charges high premium rates may be criticised by its clients but will not be viewed as a problem by its competitors, whereas an institution that charges low rates will be popular with its clients and viewed with suspicion by competitors. So, in the first instance, premium rules are needed to ensure that nobody benefitting from official export credit support (exporters, banks, foreign buyers) is too happy and that the famous "level playing field" of the Arrangement is maintained.

On the other side of the coin from those who benefit from OECD members' official export credit programmes (and whose happiness needs to be managed), there are others whose potential unhappiness is a source of concern; the first being taxpayers who are on the line if red ink appears, and the second being non-OECD governments who are concerned that their exporters could be placed at a disadvantage. Luckily (at least for taxpayers or anybody else who does not like subsidies), such concerns are addressed – at least in part – by item (j) of Annex I (Illustrative List of Export Subsidies) of the WTO Agreement on Subsidies and Countervailing Measures (ASCM), which states that export credits should not be provided "… at premium rates which are inadequate to cover the long term operating costs and losses of the programmes." This means that in addition to the very practical shared desire among OECD members to neutralise the cost of official financing as a factor in export competition, there is an international legal obligation to avoid the obvious subsidisation of official export credits by way of low premiums.

Generally, although the case for establishing disciplines on premium rates charged by ECAs was clear, whether or not it would actually be possible to establish practical rules was not!

Why are the rules so complex?

In the first place, the assessment and pricing of risk is a mixture of art and science which is complex by nature. Anyone who has ever shopped around for insurance knows that premium rates – for insuring what should be the same risk – may differ enormously. In the first place, different people (or companies) are more or less risk averse and some may demand a higher return than others for the risk that they take. Some people are better at assessing risk and may be more comfortable accepting a lower premium for some transactions if they decide to underwrite a risk. Moreover, it's impossible to compare insurance premium rates without taking into account the specific qualities of each (*e.g.* will the health insurance company pay for my broken leg due to a skiing accident or did I miss this exclusion in the fine print of the policy). Hence, the basic nature of assessing and pricing risk is not conducive to the establishment of a simple system.

On top of this, however, in order to bring people to the table, it was necessary to establish some ground rules; first and foremost this meant agreeing that no country would be forced to change its system (although the premium rates generated by each system were certainly open for discussion). This inevitably led to an incredibly complicated system. Direct lenders wanted to charge premium as a margin on the interest rate; insurers wished to charge premium on an up-front basis at the time the policy is issued, and some even insisted that they might like to charge some transactions up-front and others as a margin. This led to the establishment of intricate calculations by which every possible way that premium could be charged could be transformed into an upfront fee for comparison with the minimum rates established. But that's only the beginning. What about risk mitigation? How could we compensate for the quality and percentage of cover provided (*i.e.* the residual risk)? How could we account for the fact that premium charged as a margin may never be collected if there were to be a default (*aka* the dreaded "premium at risk" debate which brought to mind an Escher drawing)?

Other complications arose due to decisions taken by the negotiators. Perhaps the best example of this was the decision – reflecting the classic insurance approach – to express the MPRs on an up-front (instead of on a margin) basis. This added further complexity in the form of *e.g.* currency-differentiated discount rate conventions. Add to this that the system was being built to provide an MPR regime for official export credit business in general meant that there had to be a premium rate for every possible tenor, adjusted to address the factors mentioned above. And lest I forget, it is very difficult to construct a rational and mathematically coherent premium rate structure in terms of tenor when the system is based on up-front rates!

Thus, the combination of a tricky topic (risk assessment and pricing), the ground rules of the negotiations (no changes in ECAs' practices would be required), some decisions taken by the negotiators and the broad scope of business that needed to be addressed, all conspired to create the complex system that was first established when the original premium disciplines of the Knaepen Package came into force in April 1999 – and expanded in 2010 when the Malzkuhn-Drysdale Package was agreed.

The basic characteristics of the premium rules

As it was in the beginning, so it remains that the basic building block of the premium rules is a set of minimum (floor) premium rates; these MPRs are determined by certain characteristics of each credit. The difference between the 1997 and 2010 premium packages is that in the latter the MPRs reflect both country risk as well as commercial risk, with the country risk element of the premium being a function of a common country risk classification (for which there is no room for discretion), while the buyer risk portion is determined by way of a self-selected buyer risk classification (that is subject to considerable discretion). Although the determination of the applicable MPR for a particular transaction is now subject to a significant amount of discretion, as before ECAs remain free to charge rates in excess of the MPRs. The following is how the premium rules now work:

- Holding all other factors constant (*e.g.* tenor, percentage of cover, the type of official export credit product), the lowest possible rate for a transaction is determined by the country risk classification to which it is exposed; in effect this maintains the concept of a hard "floor" that was established under the Knaepen Package[1].

- Starting from the country risk anchor, ECAs are now obliged to assign a buyer risk classification to each transaction according to the buyer risk classification scheme of the Malzkuhn-Drysdale Package. The classification carries with it a premium surcharge (which is zero for sovereigns and the very best buyers in a country) which in combination with the hard floor yields the applicable MPR.

- ECAs are then free to charge a premium rate at or above the applicable MPR.

Of course this is only the basic structure of the system – hence the reference above of "holding all other factors constant" – and it should come as no surprise that the factors which determine the precise applicable MPR for a given transaction are numerous. If you would like to know more about them I invite you to visit any number of ECAs' websites that provide premium calculators that could keep one occupied for hours!

A more important aspect of the premium rules is transparency. Although transparency was an integral part of the Knaepen Package, I think that it is fair to say that it has been elevated to the level of a discipline in connection with the Malzkuhn-Drysdale Package, as a counterbalance to the amount of permitted discretion involved in assessing buyer risk. For instance, prior-notification (a non-proscriptive, but otherwise highly annoying, obligation) is required whenever the risk of a buyer is assessed as equivalent to a sovereign risk, or when the ECA's assessment of an entity is better than its rating by private agencies (such as Moody's or Standard & Poor's).

What next?

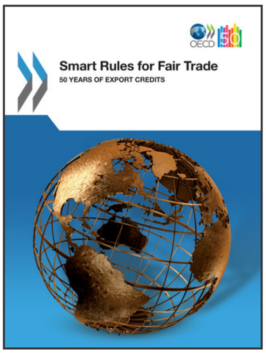
As far as we in the export credit secretariat are concerned, we will be attempting to put in place the tools needed to let people know if the system is working appropriately, and to answer the following (non-exhaustive) list of questions:

- Are there wild variations in buyer risk assessment between ECAs for the same buyer?
- Do some ECAs systematically assess buyers more favourably than other ECAs (*i.e.* did some ECAs provide an inordinate number of notifications)?
- Now that MPRs have been established for different buyer risk classifications – which to the outside world might appear to be commonly-agreed rates – have the premium rates charged by ECAs on the whole increased, decreased or remained stable?
- Is the requirement to apply market pricing in the lowest risk markets being respected?

Although the answers to some of these questions may come more quickly than others, time will be needed to see the results of the system. In my opinion, however, the fact that the new premium rules now contain a common risk-language may pave the way towards a less complicated and perhaps more market-oriented system in the future. To this end, we can't rest on our laurels. We have to ensure that the export credit rules on premium do exactly what the negotiators intended: contribute to the elimination or minimisation of subsidies in governments' export financing programmes and maintain a level and transparent playing field so that competition is constructive, not destructive.

Note

1. The possibility of applying a premium rate lower than the floor rates does exist; however, the scope for doing so is extremely limited and the premium could never be more than 10% lower (*e.g.* if the sovereign rate is 3.00%, the lowest possible rate would only be 2.70%).



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