CHAPTER V

MEDIUM/LONG TERM TRADE AND PROJECT
THE KOREAN APPROACH

CONTENTS

b. Background
c. Participants of project finance
d. Principles of project finance
e. Project phases & risk takers

3. Risks in project finance
4. Risks and Mitigants
5. KEIC's underwriting points on project finance
6. Procedure of risk assessment

TOPIC 3: PREMIUM SYSTEM IN MEDIUM & LONG TERM EXPORT CREDIT INSURANCE

1. **Principles of Premium Policy**
   1. Principles of premium
   2. ECA's principles
   3. Do ECAs reach the goal of long-term break even
   4. Trends
2. **Determining Premium Level**
   1. Factors in determining premium level
   2. OECD's efforts to establish harmonized premium level
   3. OECD's country rating scheme
   4. Premium factors of individual project

WHAT IS OFFICIALLY SUPPORTED EXPORT CREDITS?

1. **Definition**

   Loans or credits to finance the export of goods and services for which ECA in the creditor country provides guarantees, insurance, or direct financing
2. **Operating principles of Officially Supported Export credits**

   a. **Purpose**

   -facilitate & promote national export

b. **Rational of official involvement**

-correct the market failure

-defend the national exporter's interest

3. **Types of support**

(a) Financing support

-Direct financing: ECA provides direct financing to the debtors in importing countries

Interest subsidy: ECA provides an interest subsidy to the commercial banks which give direct loans to the debtors in importing countries

(b) Insurance & Guarantee

-ECA covers risks - arising in the export or export financing transactions - for the exporters or commercial banks

-Insurance & Guarantees are used interchangeably in the international financing & export credit field

-Insurance & Guarantees are generally divided into short term, medium term, and long term

- short term: usually under one year
- medium term: between one and five years
- long term: over five years

Definition of Insurance & Guarantee by IBRD:

Insurance: offered to exporters to cover the risk of non-payment by the buyer, and <u>often used interchangeably with guarantee</u>

Guarantee: <u>a type of insurance</u> offered to financial institutions to cover the risk of non-payment by the buyer

4. **Types of ECA support according to the economic development stage**

a. Advanced countries

- Insurance is the main function whereas financing is the subordinate function

b. Developing countries

- Insurance & Financing have the same importance

c. Less developed countries

- Financing is the main function whereas insurance is the subordinate function

Function of ECAs & Financial Market Condition

	ECAs' Function	**Financial Market Condition**
Advanced Countries	Insurance	Well-developed financial market
Developing Countries	Insurance & Financing	Immature financial market
Less-Developed Countries	Financing	Not developed

MEDIUM & LONG TERM EXPORT CREDIT INSURANCE

1. General Features

(a) Payment Term

-one to ten years of deferred payment

(b) Transaction Covered

-export transaction of capital goods

- Ships, aircraft, plant, etc

(c) Focus on Political Risk

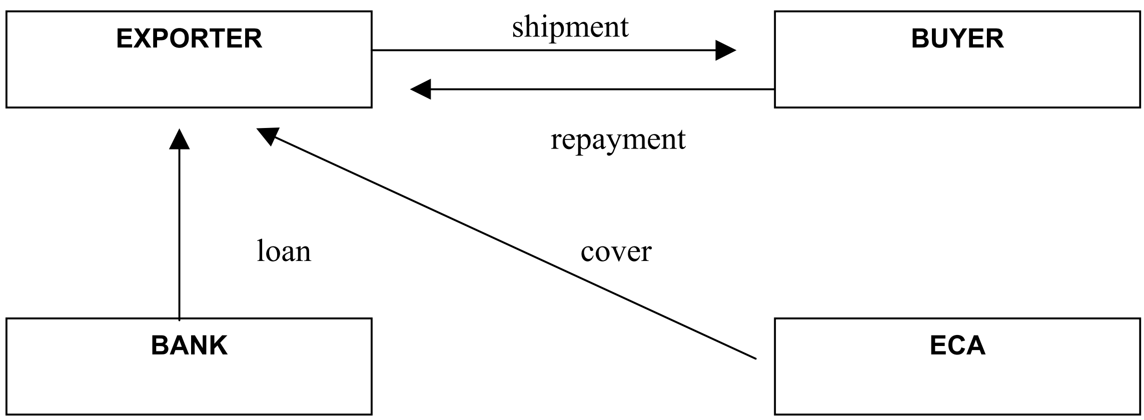
-demand for ECAs' cover is focused on political risk

Medium & Long Term vs. Short Term Insurance

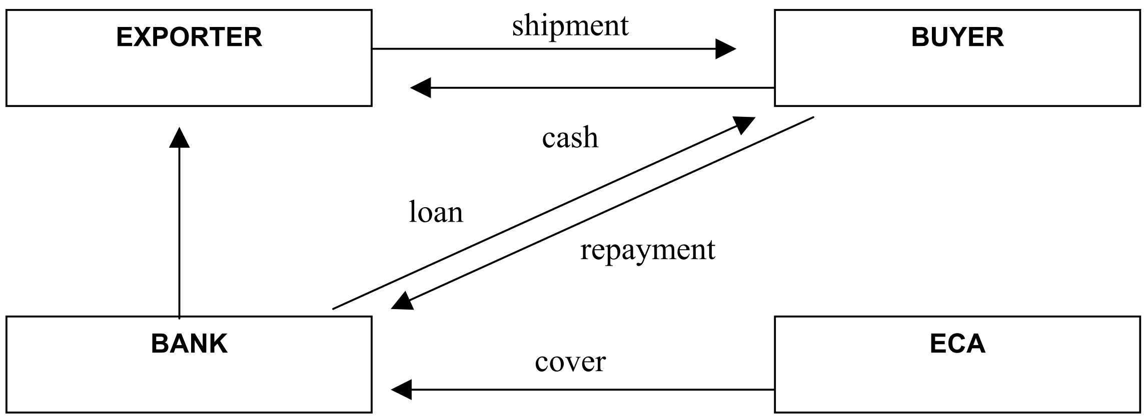
Items	M/L Term	S/T Term
Repayment Term	1 to 10 years	Up to 1 year
Goods	Capital Goods	Consumer Goods
Who Covers?	ECA	ECA, Private Insurer, etc.
Main Risk	Political Risk	Commercial Risk
Size	Big	Small
Function	Financing	Insurance

(d) Types of cover

Supplier's Credit Cover



Buyers' Credit Cover



(e) Types of Policy

Items	Continental Style	American Style
Country	European countries such as France, Germany and Japan, Korea	U.S., U.K., etc
Type	Insurance	Guarantee
Coverage	Partial	Full
Documentation Risk	Not covered	Covered
Contract Style	Policy basis	Individual Contract basis

(2) Medium & Long Term Export Credit Insurance Program of KEIC

a. Covered Transaction

-Export transaction of Capital Goods with over two years repayment period

b. Policy types

-Specific policy & Whole policy

-Suppliers' credit policy: Pre-shipment & Post-shipment

-Buyers' credit policy

c. Risks Covered

-Preshipment (pre-credit) risk & Postshipment (post-credit) risk

-Political risk & Commercial risk

d. Matrix of risk covered

Scope	**Political risk**	**Commercial Risk**
Pre-shipment	**Cover**	**Off cover**
Post-shipment	**Cover**	**Cover**

Definition of the risks

Shipment

Preshipment

Political risk
a. Government action of preventing the import b. Breach of purchasing contract by public buyer c. War, civil war, revolution, etc.preventing the exporter from performing his obligation

Commercial risk
Cancellation of purchasing contract by private buyer

Postshipment

Political risk
a. Government action of preventing the repayment b. Failure of repayment by public buyer c. War, civil war, revolution, etc. preventing the buyer from making repayment

Commercial risk
Failure of repayment by private buyer (default, bankruptcy, etc.)

New Trends on Political Risk Cover

Traditional viewpoint of ECAs to political risk

-distinctively separate from commercial risk

-mainly associated with transfer risk, typically the risk of Paris Club rescheduling caused by shortage of foreign currency

-primarily related with individual debtor countries

New trends of global economy

Privatization	**Deregulation**	**Globalization**

-big rush of privatization in developing countries ex)Asian countries, East European countries, South American countries -traditional public projects are initiated by private sector	-deregulation of currency regimes & financial sector ex) flexible exchange rate system, flexible interest rate system -traditional controlling power of Government on the currency & finance is transferred to private sector	-the opening-up of national economy ex)patterns of capital flow become diverse -loan from banks & ECAs (traditional) +foreign direct investment +portfolio investment +bonds

Influence of the new trends on ECA

Privatization	**Deregulation**	**Globalization**
-drastic decline of the proportion of pure sovereign risks in ECAs' total business -increase in demand for commercial & project risk -project finance is popular	-national economy becomes vulnerable to the external shock -transfer delay & Paris Club rescheduling will be no more typical pattern of risk -depreciation of local currency & payment problem of individual buyer is becoming important risk to consider	-country risk analysis needs more information of the global influence on a national economy -diverse creditors of a nation will influence the negotiation procedure or pattern of the debt rescheduling

e. Coverage

Insurable amount	**Contract amount - down payment + deferred interest**

Insured amount	**Coverage ratio x insurable amount**
Coverage ratio	**95%**

Cf.) Coverage ration of other ECAs

-Coface, Hermes, SACE and lots of European ECAs: 95%

-U.S. EXIM, ECGD: 100%

-EID/MITI: 97.5%

Insurable Amount of ECAS

	KEIC	**U.S.EXIM**	**ECGD**
Maximum (OECD Guideline)	85% of contract amount + deferred interest	same as KEIC	same as KEIC
Insurable amount	Same as above	U.S. content amount within the above maximum limit	U.K. content amount + EU content (within the limit of 30% of total contract amount) + foreign content (limit of 15% of T.C.A.)
Minimum requirement of national content	30%	50%	30%

f. Claim Period

-bankruptcy: immediately

-delay: three months after the due date

g. Indemnified Amount

-unpaid principal & interest

-interest from the due date to the date of indemnification (KEIC does not cover but is planning to)

h. Two types of indemnification

	Explanation	**Applied Policy**
Pro rata indemnification system	Indemnified Amount = real loss x coverage ratio	Post-shipment cover policy
Real loss indemnification system	Indemnified Amount = real loss =<Insured amount	Pre-shipment cover policy
WHY?	-pro rata system is used in case of high coverage ratio, i.e. high possibility of total loss -real loss indemnification system is used in case of low coverage ratio, i.e. high possibility of partial loss -in case of pre-shipment cover, real loss system is applied because indemnification is made after deduction of the value of non-exported goods & the expected margin of the transaction	

How much interest should be covered?

Q. If a lender receives a good deal in loan negotiation with higher interest rate than the usual one, should ECA cover the high interest rate or the usual one?

A. Guaranteed interest rate of ECA is not necessarily equal to the contract interest rate?

-KEIC usually covers the contract denominated interest rate, but if we find an excessive margin for the lender, we can cover on a usual basis

-Other ECAs' practice is the same as KEIC

i. Recovery

Commercial risk

-debt collection agency
-lawsuit
-negotiation with the buyer
-notification to ECAs
-recover the goods & resell

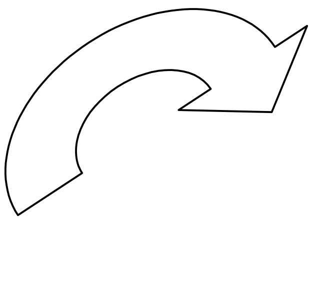
Political risk

-bilateral negotiation
(Government to Government)
-multilateral negotiation
(Paris Club meeting_
-ECAs' common line to the country

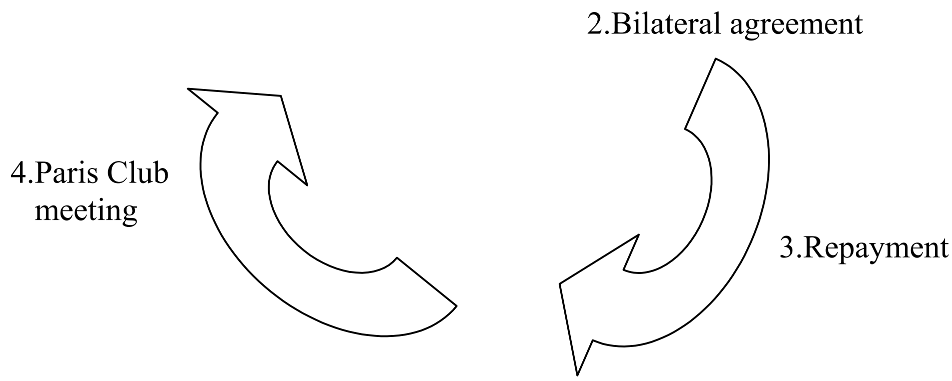
3.Paris Club Rescheduling

a. What is Paris club rescheduling
   -creditor countries' meeting to discuss rescheduling terms in case of a payment problem in the importing country
b. Debt rescheduled in Paris Club
   -officially financed debt with over 1 year repayment term
   -debt related to export credit insurance with over one year repayment term
c. Profile of Paris Club Rescheduling
   -rescheduled 250b dollars with 61 countries since 1976

Procedure of Paris Club Rescheduling



1.Investigation of Official Credit



RISK IN MEDIUM & LONG TERM EXPORT CREDIT INSURANCE

1. **Risk Phases**

   -Pre-completion Risk: failure to complete project

   -Post-completion Risk: failure to repay

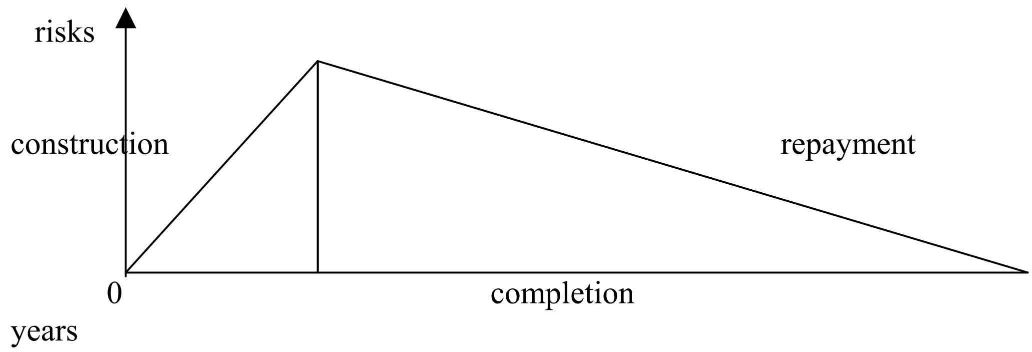
2. **Types of risk**

   -political risk

   cf.) extended political risk

   -commercial risk or project risk

Project Risk Phases



1. Project Risk Assessment of ECAs: Past & Present

   a. Past Practice

      -ECAs' risk assessment was focused on the country risk analysis

      -ECAs had little appetite for commercial risk or project risk

   b. New Trends

-rush of privatization in many developing countries

-spotlight on project finance

-ECAs face new demand for project risk or commercial risk

Traditional approach and new approach on risk assessment

	Traditional	New
Project type Main concern	-Public project with MOF guaranteed financing -Private project with 1st class bank guaranteed financing -country risk	-Private project with non-recourse or limited recourse financing (Project Finance) -Project risk (establishment of independent project finance team)

Past:
Guarantee based project

a. Government's will & ability to pay
b. Importing country's payment experience
c. Balance of payments
d. Capital flow to the importing country
e. Priority of the project in the importing country
f. Credit status of buyer or guarantor in a private project

Present:
Limited recourse project finance

A Government's supporting policy for the business & the possibility of termination or suspension of the support ex) exemption of tariff, tax benefit, transfer guarantee, etc.

Analysis of the legal, political, social & economical environment for the project, and the influence of the change of the environment on the project feasibility

Project feasibility with cash flow analysis

2 Risk Assessment in Project Finance

a. What is Project Finance

-non-recourse financing

-limited recourse financing

-asset based financing

b. Background

-privatization: high demand of infrastructure in developing countries & limitation of Government capability to finance

-deflation of the economy of advanced countries

-pursuing the high-yield financing of the banks

c. Participants in Project Finance

1) sponsors
2) project company
3) EPC contractors and sub contractors - EPC: Engineering, Procurement & Construction
4) Lenders
5) ECAs
6) Others

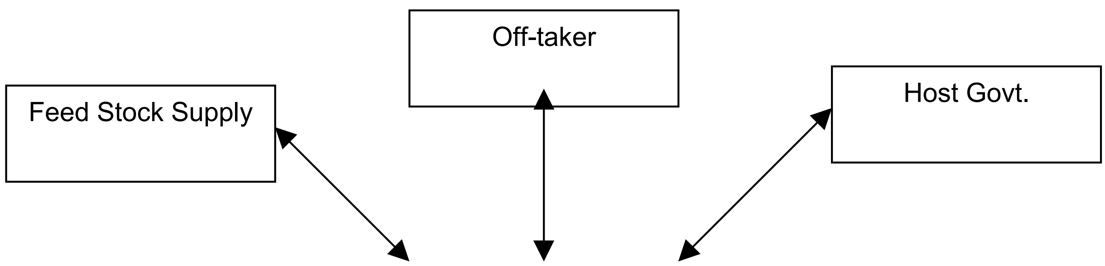
   -feed stock suppliers

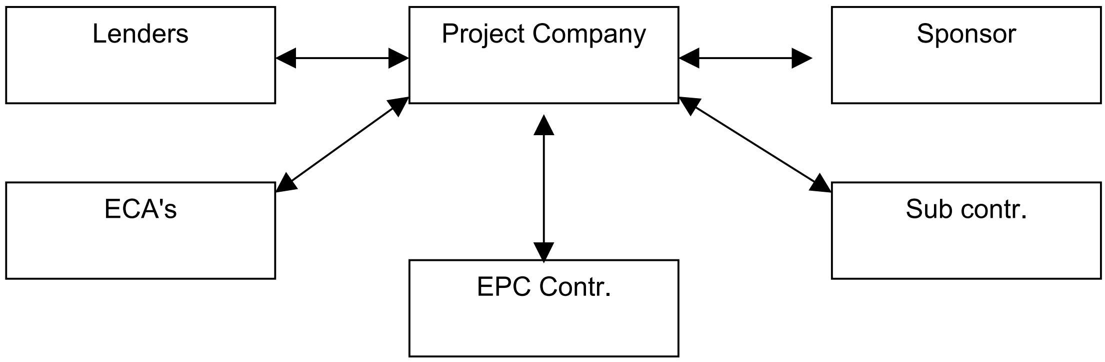
   long term off-takers

   host government

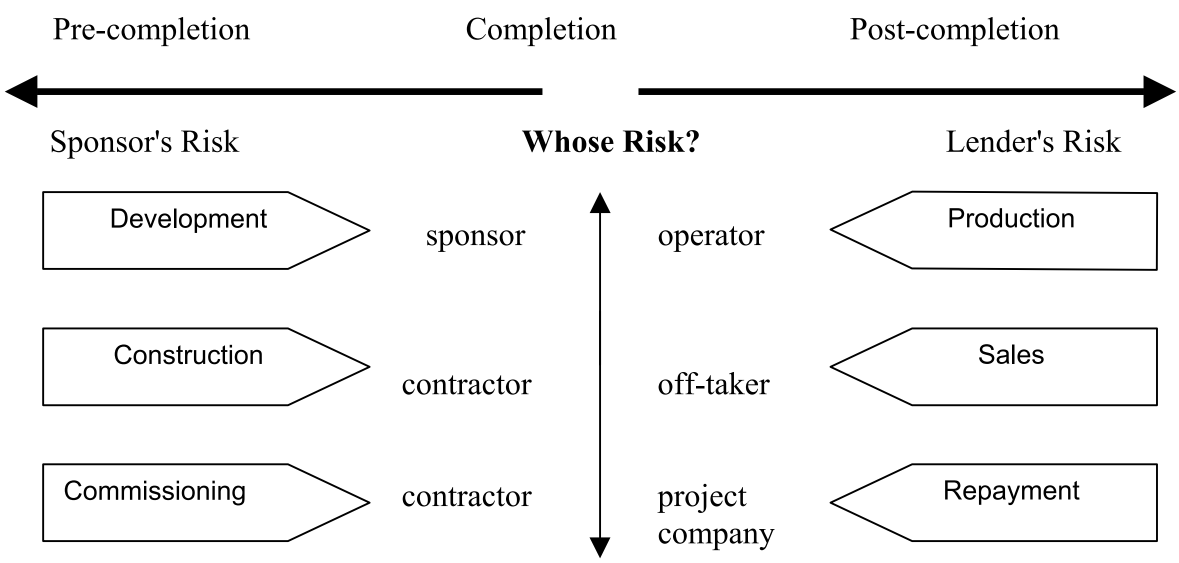
7) advisors of sponsors & lenders

GENERAL STRUCTURE OF P.F.





e) Project Phases & Risk Takers



3. Risks in Project Finance

- Completion
- Delay
- Cost-overrun
- Country
- Operation
- Market
- Cash-flow

4. Risks and Mitigants

Risks	Mitigants
Bankruptcy of contractor	
Failure of equity subscription by sponsor	Equity subscription of sponsors shall be made before the loan disbursement
Failure of completion	Completion guarantee of sponsors which is a kind of payment guarantee
Cancellation of Government licence	Letter of comfort issued by host Government
Force majeure	Insurance cover for damages to project in the event of a fire, flood, etc.

• Bankruptcy of contractor • Failure of equity subscription by sponsor	Equity subscription of sponsors shall be made before the loan disbursement
Failure of Completion	Completion guarantee of sponsors which is a kind of payment guarantee Letter of comfort issued by host Government
• Cancellation of Government licence • Force majeure	Insurance cover for damages to project in the event of a fire, flood, etc.
	Set up the rational project schedule with the help of an independent consultant
Delay of Completion	Date certain construction contract with the liquidated damage clause which can cover financing cost during the delayed period
Project is not proceeding within the expected schedule	Review the contractor's past record to perform the same kind of project
Incorrect evaluation of the cost Abuse of the funds Additional cost incurred by host government	Cost evaluation of an independent consultant

Cost over-run	Fixed price construction contract -construction cost over-run is covered by the contractor sponsor's guarantee for the cost over-run
Project cost exceeds the budget	-sponsor covers the cost over-run by other reasons except the construction cost
Host Govt's breach of undertaking -cancellation of licence, tax benefit, etc -restriction on transferring foreign currency War, insurrection, revolution, etc	
Country Risk	Letter of Comfort from host Government -if possible, legally binding one Establishment of Escrow Account -if the project generates revenue in hard currencies
Economic difficult in Host country	Co-financing or joint financing with other ECAs and Multilateral Agencies
New technology -output doesn't reach to the expected level of quantity & quality -break down of the plant	Use old proven technology -if it is a new technology, thorough feasibility study should be made
Operation Risk	Reliable & experienced operator Bonus/Penalty clause in the O & M Contract Cap on the operating cost or indexed to revenue
Inexperienced operator -operator is not accustomed to the technology applied to the operation of the plant	

Failure of sales -fluctuation of market condition	Long term off take agreement with creditworthy purchaser -not always possible -wholesale product vs. retail product
Market Risk	Market research performed by an independent consultant
Decrease of sales volume -production of new items which can substitute for items produced by the project Price down -supply exceeds the demand	Host Government's guarantee for price support (e.g. power plant) or minium passage guarantee (e.g. toll road, pipelines)
Failure of expectation -cost-up by excessive inflation -debt service increased by unusual depreciation or hike of interest rate	Cash deficiency guarantee of the sponsors -limits in amount or period
Cashflow Risk	Price indexed to inflation or exchange rate -selling price is indexed to the manufacturing cost & debt service amount
Increase of capital expenditure -new guideline is imposed on the plant (e.g.new guideline on environment)	Conservative estimate of the variables

5. KEIC's underwriting check points on project fiance

- What is the creditworthiness status of participants?
- What are the major risk factors in the host country?
- Is the project in an important sector in the host country?
- Does the project generate revenue in hard currencies?

- Does the project have a long-term off-take agreement?
- What support does host government give to the project?
- What is the debt equity ratio?
- Has the proper due diligence been planned?
- What does the completion guarantee of the sponsor cover?
- Does the project generate enough cash flow to repay the loan?
- Do the repayment terms satisfy the OECD Consensus?

6. Procedure of Risk Assessment

Random Assessment	**Regular Assessment**
• Creditworthiness of sponsor	• Creditworthiness of project participants
• Market risk	• Deep study on all the risk factors -market risk, feed stock supply risk, operation & maintenance risk • Deep assessment on country risk
• Attitude of host government	• Assistance from independent consultants • Documentation
• Overall country risk assessment	• Securities
Issue of Letter of Intent	Issue of Policy

<u>**Topic3: Premium System in Medium & Long Term Export Credit Insurance**</u>

<u>PRINCIPLES OF PREMIUM POLICY</u>

1. Principles of Premium

-enough to maintain sound insurance business

-enough to save some portion of profit for dividends & reinvestments

-closely related with the amount of risks

2. ECA's principles

   -enough to cover claims & operation cost on a long term basis

   -long term break-even is the main target: World Trade Organisation E.C.A.'s are required to break even over time and not subsidise

3. Do ECAs reach the goal of long-term break even?

   -average loss ratio of ECAs in advanced countries is about 400-500% and the accumulated amount of loss about USD100billion.

   -Dilemma of ECAs; promote nations exports while meeting WTO guidelines of long term break even.

4. Trends

   -raise the overall premium level

   -strengthen the country risk assessment and project appraisal

DETERMINING PREMIUM LEVEL

1. Factors of determining premium
   a. country risk factor
      - 4 to 8 categories of country rating

        -KEIC has 8 categories
      - Key factors of country rating

-payment record, external debt, debt service ratio, etc

- Gap in premium level according to categories

  -premium of 8th category is eight times the 1st category

b. Other factors

- Repayment period
- Buyer's type

  -public buyer gets 10% discount in KEIC system

- Payment guarantee

  -25% discount in KEIC's system

- Policy type

  -political risk only policy

  -comprehensive risk policy

*KEIC has no political risk only policy

2. OECD's efforts to establish harmonized premium level

- Background of the harmonization

  -prevent a credit race among ECAs

  -big difference in premium level among ECAs

  -eliminate the export subsidy granted by ECAs due to low premium level

- Consultation in OECD

  -begun in May, 1994

  -concluded in June, 1997

3. OECD's country rating scheme

- Countries rated

  -70 countries other than OECD countries

- factors of rating

  payment experience

  financial situation

  economic situation

  political situation

- rating procedure

  -1st stage: quantitative evaluation

2nd stage: qualitative evaluation

- **Premium table by country category**

1	2	3	4	5	6	7
1.50	2.94	4.91	7.23	9.77	12.13	14.68

*On the basis of 11.5 year repayment period

- **Major countries in each category**

-1st: Singapore, Taiwan, HongKong, Malaysia

-2nd: China, Czech, Chile, Thailand

-3rd: Hungary, Poland, etc. (13 countries)

-4th: Saudi Arabia, Mexico, etc (10 countries)

-5th: Romania, Russia, Turkey, Vietnam, etc. (15 countries)

-6th: Pakistan, Iran, Algeria, etc. (11 countries)

-7th: Angola, Bulgaria, Iraq, Libya, etc. (13 countries)

4. Premium Factors of individual project

   a. country grade category

   b. exposure period

   -half of loan drawdown period + repayment period

   -premium level rises as the exposure period increases

   e.g.: premium rate of a project with 10 year exposure period in 4th grade country is 6.35%, and a project with 12 year exposure period in the same category is 7.52%

   c. quality of policy

   -coverage, guarantee or insurance, cover the interest incurred from the due date to indemnification or not.