Country and Sovereign Risk Analysis
SACE Global Solutions

Aman Union Training Course 2016
Jeddah, May 3 – 4 2016

GRUPPO CASSA DEPOSITI E PRESTITI

SACE
IL MADE IN ITALY NON SI FERMA MAI

SACE Global Solutions

Global Solutions is a SACE dedicated service, providing advisory and training programs aimed at transferring own experience and know how to ECAs/EXIMs, ministries and financial institutions

Dedicated to	ECAs/EXIMs, ministries and financial institutions such as foreign banks, multilaterals and IFIs.
Learning modalities	• Technical assistance for the set-up and development of an Export Credit Agency or EXIM bank; • 'Tailor-made' programs for ECAs/EXIMs that want to improve their skills on specific products, policies and due diligence; • Seminars and workshops dedicated to banks and other financial institutions on trade finance and export credit issues.
Tuition	Provided by highly qualified professionals, with know-how based on proven working experience.

Country and Sovereign Risk Analysis

Specific objectives of this training

Specific objectives:

- ✓ Understand the key drivers of country risk in both mature and emerging markets.
- ✓ Identify qualitative and quantitative indicators of vulnerability.
- ✓ Present SACE's multidimensional approach.
- ✓ Define the main elements of PRI.
- ✓ Identify qualitative and quantitative indicators of vulnerability for sovereign and sub-sovereign counterparts.

Global solutions: a dedicated structure to transfer experience and know-how

Why we talk about country risk?

When a firm starts to expand internationally, it is faced with a new environment composed of different risks and uncertainties which is not used to deal with.

Country Risk encompasses all these specific sources of potential difficulties encountered when investing overseas, ranging from political and social risks to macro and microeconomic risk.

"Country Risk" is a sort of catchall term that refers to miscellaneous risks and includes all the additional risks induced by doing business abroad, as opposed to domestic transactions.

Country Risk Definition

*"All business transactions involve some degree of risk. When business transactions occur **across international borders**, they carry additional risks not present in domestic transactions.*
*These additional risks, called country risks, typically include **risks arising from a variety of national differences in economic structures, policies, socio-political institutions, geography, and currencies**.*

*Country risk analysis attempts to identify the potential for these risks to d**ecrease the expected return** of a cross-border investment".*

Meldrum, D.H. (2000). Country Risk and Foreign Direct Investment, Business Economics, Vol. 34, No.3.

Sovereign	Political	Economic	Transfer	Position
A government becomes unwilling or unable to meet its loan obligations, or reneges on loans it guarantees.	Change in political institutions stemming from a change in government control, or other non-economic factor.	A significant change in the economic structure or growth rate that produces a major change in the expected return of an investment.	The risk arising from a decision by a foreign government to restrict capital Movements.	Spillover effects caused by problems in a region, or in countries with similar perceived characteristics.

Different types of risks

- **Country risk** refers to the risks associated with doing business in a particular country
- **Political risk** refers to the risks generated by political changes or instability in a country or arbitrary regulations approved by the host government against foreign investors
- **Sovereign risk** is more narrowly focused on the risk of a sovereign government defaulting on its debt obligation
- **Sub sovereign risk** refers to risk of non-payment of regional and local governments as well as public-sector entities with specialized mandates

Definition of sovereign default

Sovereign Default:

- Failure or refusal of a country's government to repay all (or substantially all) its debts and financial obligations

Restricted Default or Selective Default (for Rating Agencies):

- Failure of a sovereign entity to make due payments (within the applicable grace period) on some but not all material financial obligations, but continue to honor other classes of obligations.

Illiquidity vs. insolvency

Illiquidity

occurs when a firm or country has a temporary cash flow problem. Its assets are greater than its debts, but some assets are illiquid (e.g. it takes a long time to sell a house. A bank can't suddenly demand a mortgage loan back) Therefore although in theory assets are greater than debts, it can't meet its current payment requirements.

Insolvency

occurs when a country has debts that it can't meet through its assets. i.e. even if it could sell all its assets, it would still be unable to repay its debts.

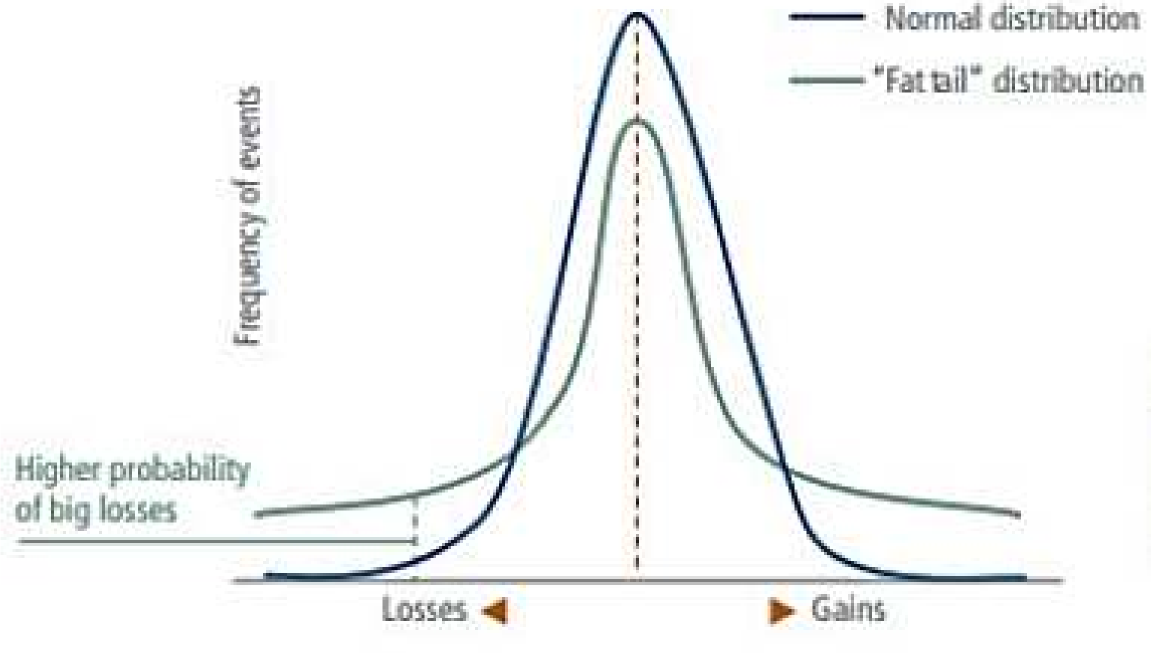
Fat Tail Risk: definition

*What do we mean by a "fat tail?" Fat tails are the unexpectedly thick "tails" – or bulges – that we find on the tail ends of **distribution curves that measure risks and their impact**.*

*They represent **the risk that a particular event will occur** that appears so **catastrophically damaging**, **unlikely to happen**, and **difficult to predict**, that many of us choose to simply ignore it. Until it happens.*

Ian Bremmer and Preston Keat (2009), The Fat Tail, the power of political Knowledge for strategic investing, Oxford University Press.

Fat Tail Risk Curve



Source: Financial Times

Tail events are very rare in a normal curve, but market tails are in fact "fatter", or more frequent, than many people realize.

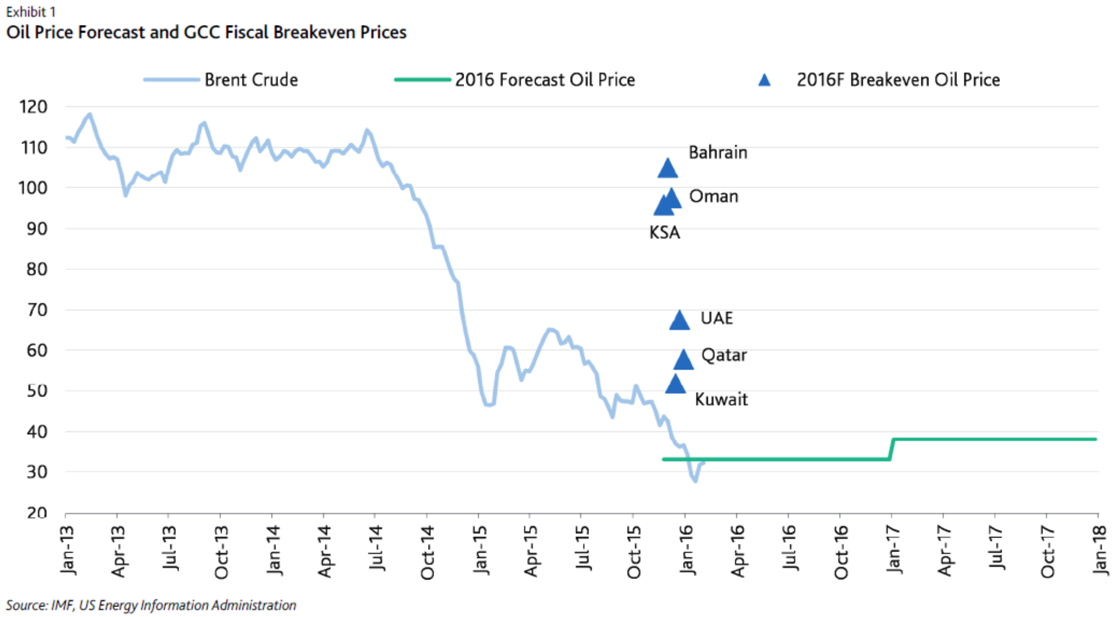
SACE

Sources of information

- **IFIs** (IMF, WB, Regional Development Banks,)
- **International Institutions** (OECD, Berne Union)
- **Central Banks**
- **Private Research Institutes** (EIU, Global Insight, Oxford Analytica, IIF, Datastream, Business Monitor Int. Etc.)
- **Press** (Financial Times, Wall Street Journal, Economist, etc.)
- **Rating Agencies** (Moody's, Standard & Poor’s, Fitch’s)

Macroeconomic analysis: drivers and weaknesses

Oil sector



Targets:

Commodity price
Public Finance
External Debt and Int. Reserves
Banking sector

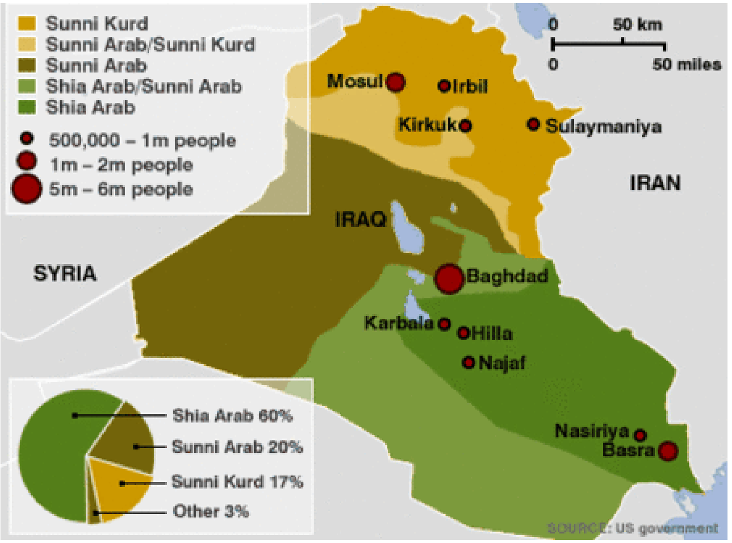
Sources

〉 Local Government, Central Bank	Statistical Report, Procedures
〉 Multilateral	IMF, WB, IIF, OECD,OPEC
〉 Info provider	Bloomberg, Haver, Datastream
〉 Commercial/Int. Banks (Research Dept)	Barclay's
〉 Rating Agency	S&P's, Moody's, Fitch

Institutional framework

Target

Political agenda
Electoral calendar
International Relations

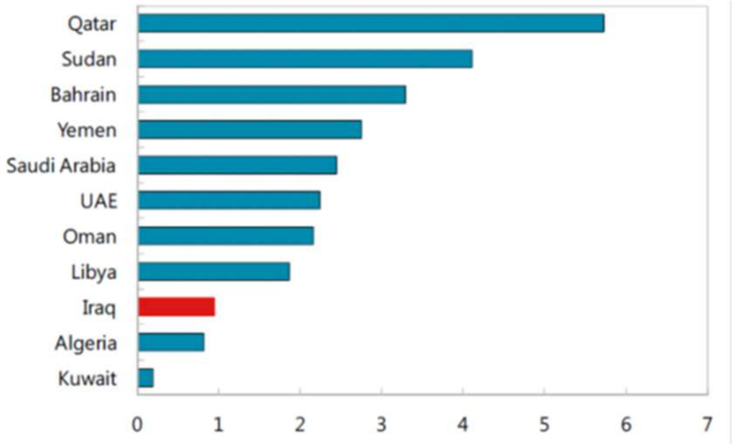


Sources

- Local Press
- Info provider
  (Oxford Analytica, Global Insight, BMI)
- Multilateral/International Organization

Business climate

FDI in Iraq, 2012 (% GDP)

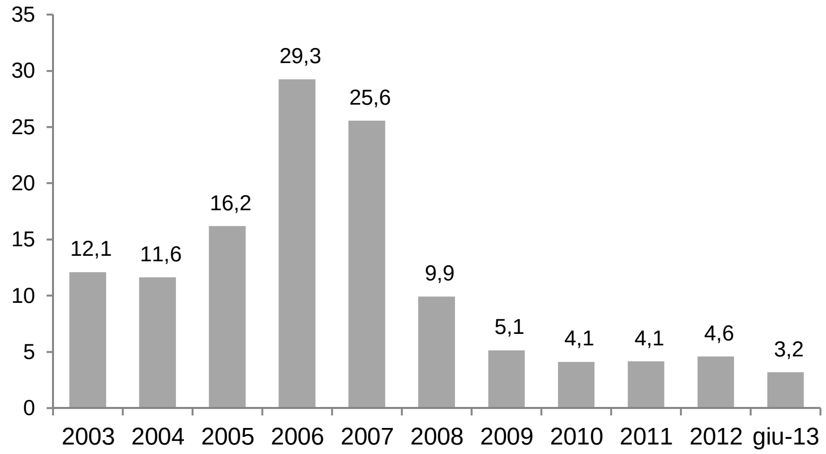


Source: IMF

Targets

- Legal framework
- Openness/Restrictions Upon Foreign Investment
- Infrastructure
- Security

Violence in Iraq (civil casualties)



Source: Iraq Body Count

Sources

- Ease of Doing Business
- Corruption Perception Index
- ICSID
- Bilateral Investment treaties (UNCTAD)
- World Bank – World Development Indicators
- Local Embassy
- UN Agencies

Early Warning Indicators

Quantitative

- Macroeconomic indicators
- Market indicators

Qualitative

- Social political indicators

Macroeconomic indicators

Real GDP Growth	< 2% p.a.
Inflation	> 10% p.a.
Unemployment	> 10% p.a.
Fiscal deficit	> 3% of GDP
Current account deficit	> 3% of GDP
Liquidity	< 100%
Foreign debt	> 50% of GDP
Net foreign debt/exports	> 75%
Investment & savings	< 20% of GDP

Case Study: Argentina's crisis (2001)

Indicators	1996	1997	1998	1999	2000
Real GDP growth (%)	5.5	8.1	3.9	-3.4	-0.5
Unemployment (% of labour force)	17.1	16.1	13.2	14.5	14.7
Consumer prices (annual average change %)	0.2	0.5	0.9	-1.2	-0.9
Gross domestic savings/GDP (%)	19.0	18.6	18.5	16.6	17.0
General government balance/GDP (%)	-4.2	-2.0	-2.2	-4.5	-3.6
General government debt/GDP (%)	40.8	38.6	40.9	47.4	51.2
Broad money (% change December to December)	18.8	25.5	10.5	4.1	1.5
ARS per USD (annual average)	1.000	1.000	1.000	1.000	1.000
Real effective exchange rate (1995=100)	96.6	100.0	102.1	121.4	120.3
Current external receipts, CXR (USD bn)	33.5	37.1	37.9	34.5	39.0
Current receipts (annual % change)	11.1	10.8	2.2	-8.9	12.9
Current external payments (CXP) (USD bn)	40.3	49.4	52.5	46.6	48.0
Current external payments (annual % change)	14.2	22.5	6.2	-11.3	3.0
Current account balance (USD bn)	-6.9	-12.3	-14.6	-12.0	-9.0
Current account balance / GDP (%)	-2.5	-4.2	-4.9	-4.2	-3.1
Gross external debt (USD bn)	111.6	125.0	140.7	146.4	147.3
Gross external debt / GDP (%)	41.0	42.7	47.0	51.7	51.6
Gross external debt /CXR (%)	333.7	337.2	371.4	424.1	377.7
Net external debt (USD bn)	78.4	81.9	96.5	102.6	102.5
Net external debt / GDP (%)	28.8	27.9	32.3	36.2	35.9
Net external debt / CXR (%)	234.5	220.8	254.6	297.1	262.9
Short-term debt / Gross external debt (%)	17.7	16.3	14.9	14.4	14.2
Debt service / CXR	47.0	46.9	56.0	71.7	75.2
Interest service / CXR	22.0	23.8	27.3	32.8	31.6
Liquidity ratio (%)	61.4	76.4	91.3	87.9	80.3
Official reserves including gold (USD bn)	19.7	22.4	24.9	26.4	25.2
Official reserves in months of CXP cover	5.9	5.4	5.7	6.8	6.3

Case Study: Argentina

Country	Argentina
Year	1999
Risk	Project Finance
Project	Construction of a fertilizer plant
Debtor	Fertilizer Company
SACE Facility	USD 130.000.000
Percentage of cover	95% commercial and political
Tenor	5y

Political Problems:

- ✓ Peg of the currency to the USD in an attempt to control domestic prices
- ✓ Imports very cheap and consequently rising unemployment
- ✓ Current account deficits
- ✓ Persistent government budget deficits over a number of years resulted in accumulating national debt and a gradual increase in the burden of debt service
- ✓ Very poor domestic saving ratio of 16-18%
- ✓ Corruption and tax avoidance were endemic, limiting the government's ability to balance its budgets

Economic Factors:

- ✓ External shocks which increased the perceived credit risk: 1) US Federal Reserve's decision to raise short-term rates in February of 1994; 2) Mexican, Asian, Russian, and Brazilian financial crises (1995-1999)
- ✓ Decline in government revenue due to recession, which began in the third quarter of 1998
- ✓ Fears regarding the governments continued ability to support the currency run on the Argentine banking system and transfer of saving offshore accounts)

Table 1. Latvia: Selected Economic Indicators, 2007–10

	2007	2008	2009	2010
		Actual	Est.	Est.
Output		(Annual growth rate, in percent)		
Real GDP	10.0	-4.6	-18.0	-4.0
Private consumption	14.8	-11.0	-25.3	-8.0
Public consumption	3.7	1.5	-12.0	-10.0
Gross fixed investment	7.5	-13.2	-29.0	-11.5
Exports of goods and services	9.9	-1.3	-15.5	1.3
Imports of goods and services	14.8	-13.6	-28.5	-10.0
Prices, and employment				
HICP (average; in percent)	10.1	15.3	3.1	-3.5
(End-of-period; in percent)	14.0	10.4	-1.7	-2.6
Unemployment rate (LFS definition; in percent) 1/	6.2	7.8	15.8	17.4
Real gross wages 1/	19.7	4.4	-14.6	-4.7
Consolidated general government 2/		(In percent of GDP)		
Revenue	36.2	35.2	35.3	35.6
Expenditure and net lending	35.6	38.5	48.4	47.6
Basic fiscal balance	0.7	-3.3	-13.0	-12.0
General government gross debt	7.8	17.0	43.5	74.2
Balance of payments		(In percent of GDP, unless otherwise stated)		
Gross official reserves (in billions of euros)	3.966	3.697	3.392	4.397
(In months of prospective imports of GNFS)	3.8	6.3	6.3	7.6
(in percent of M2X and non-resident deposits)	21.8	23.5	26.0	35.5
Current account balance	-22.5	-12.6	4.5	6.4
Trade balance	-23.9	-17.0	-8.3	-5.6
Exports of goods and services	41.2	41.4	36.6	32.2
Imports of goods and services	-61.8	-54.4	-38.0	-31.8
Gross external debt	126.8	126.9	160.8	171.3
Net external debt 3/	48.2	56.0	65.7	67.0

Case Study: Latvia's Sovereign Guarantee

Critical factors:

- ✓ Public discontent was a concern due to the austery measures requested by IMF and EU
- ✓ The economic situation deteriorated markedly reflecting the collapse of domestic demand, the unwinding of the credit and real estate bubble, and the much worse than expected international environment
- ✓ Rapid correction in the current account
- ✓ eroded government revenues, opening a large fiscal gap
- ✓ Increased losses in the financial sector (high NPLs)
- ✓ Latvia's exchange rate peg faced waves of heavy pressure

Country	Argentina
Year	2009
Product	Buyer's credit Policy
Project	Revamping of a steel plant
Debtor	National Steel Company
Guarantor	MOF
Project amount	Euro 95.000.000
SACE Facility	Euro 68.000.000
Percentage of cover	95% commercial and political
Tenor	19m + 8,5y

Market Indicators of Sovereign and Country Risk

- Equity indicators
  - Stock market performance
  - Portfolio inflows
  - Foreign direct investment
  - Price/Earnings

- Debt indicators
  - CDS prices
  - Bonds spreads

BTA: A fairy tale on CDS

State-controlled **BTA Bank**, Kazakhstan's third largest lender, defaulted on January 2008. In 2009 it fell under the control of the government.

Initially BTA wanted to keep servicing its loans, and its creditors appeared happy to play along. However two banks suddenly demanded repayment and accelerated the loans.

BTA was unable to comply, and thus tipped into default.

Why?

Just after calling in the loan, the two banks asked ISDA (International Swaps and Derivatives Association) to start formal proceedings to settle credit default swaps contracts written on BTA.

Those banks had not only a loan but also a big CDS position on BTA, that pays out if – and only if – the Kazakh bank goes into default.

The banks might have deliberately provoked the default of BTA to profit on its CDS, since a default makes the banks a net winner.

In theory, lenders should have an interest in avoiding default. In practice, CDS players do not.

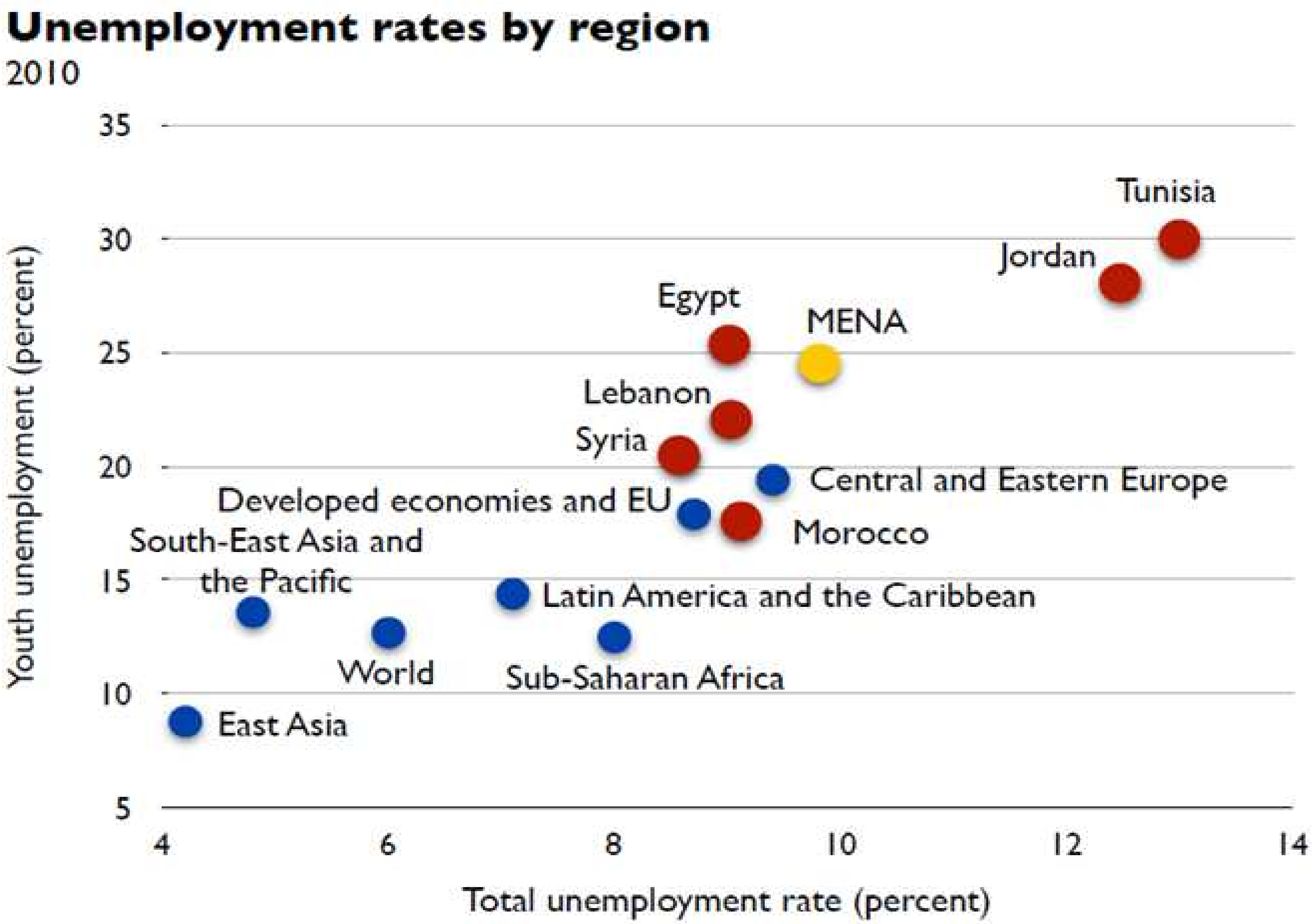
Qualitative early warning signals

Social and Political factors

- War external or civil
- Military intervention
- Political stability
- Health conditions/epidemic contagions
- High income disparity

SACE

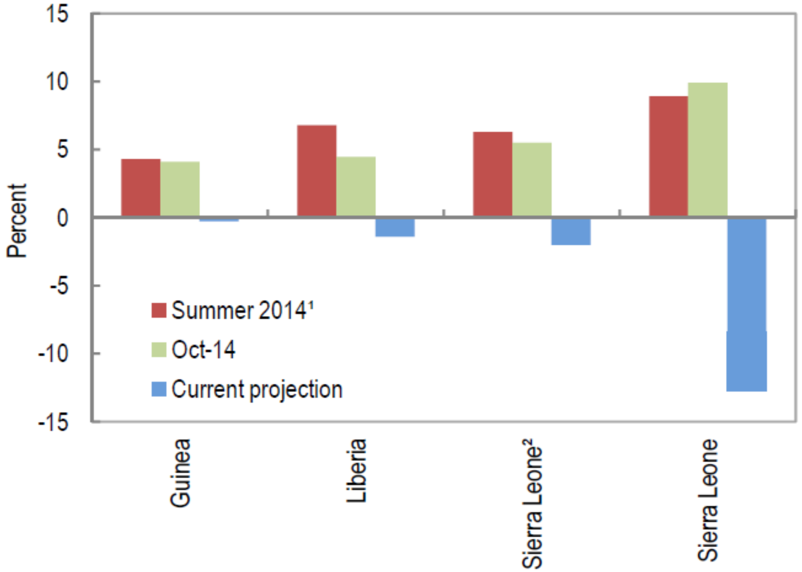
Example: the Arab spring



Sources: IMF Regional Economic Outlook: Middle East and Central and Central Asia , April 2012

Example: The impact of Ebola outbreak

Figure 1.23. Sub-Saharan Africa: Real GDP Growth Forecasts, 2015

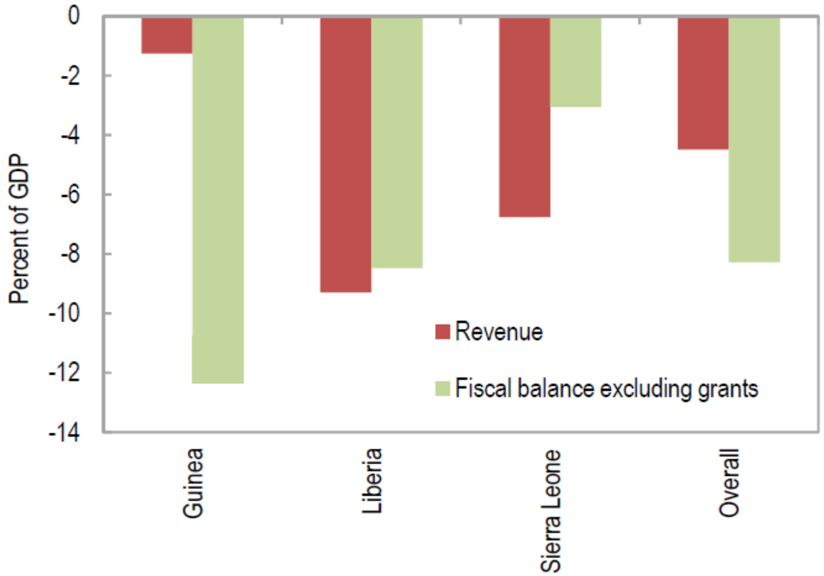


Sources: IMF, World Economic Outlook database; and IMF staff estimates.

[1] The summer 2014 projections are taken from IMF country reports (IMF 2014b, 2014c, 2014d).

[2] Growth in real GDP excluding iron ore.

Figure 1.24. Changes in 2014–15 Revenue and Fiscal Balance Excluding Grants Compared to Summer 2014 Projections



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

Conclusions: Common causes of crises

- Large macroeconomic balances
  - Current account, fiscal deficit
- Short term financing of deficits
- Credibility of country’s commitment to assure creditworthiness
- Fixed or semi-fixed exchange rates
- Poor banking regulation/government policies distorting credit allocation
- Political shocks and social factors: elections, scandals, political violence
- External shocks-commodity, terms of trade, interest rates

Source: Institute for International Economics “Bail out Bail In”; Nouriel Rubini.

Country and Sovereign Risk Analysis

Two complementary methodologies

CRAM

Country Risk Index

Global Solutions

How OECD methodology works

- OECD measures the country **Credit Risk**

  (i.e. the likelihood that a country will service its external debt)

- **Countries are classified into 8 risk categories from 0 to 7:**

  0 used to represent a negligible risk (EU countries, USA, Japan, etc.);

  7 represents the maximum risk level (i.e. Argentina, Afghanistan, Zimbabwe, etc)

- Each category **identifies** the sovereign counterparts' **probability of MLT default** and **establishes the Minimum Premium Rate** (MPR) charged by ECAs to insure sovereign risks.

  MPR is not applied to category 0 countries.

- The **classification procedure** (based on yearly revision of all countries, on a quarterly basis according to geographical areas) includes two basic components:

  1. **Country Risk Assessment Model** (CRAM)
  2. **Qualitative adjustment** of the model results based on factors not taken into account (i.e. political situation of the country)

OECD CRAM

ECA Payment Experience

Arrears/Commitments

Claims/Commitments

Economic Situation

External debt/Reserves

External debt/GDP

External debt Service/Reserves

FX reserves (month of import)

Financial Situation

Growth Potential
Inv. Rate/Savings rate
GDP per capita
Long-term growth rate

Policy Performance
Inflation
Budget balance
Current account balance

Vulnerability to external shocks
Smallness
Export diversification
Fuel imports
Official aid

Qualitative Adjustment

Political stability
Social tensions

Expropriation,
Political violence,
Transfer risk

Score

Score

Qualit. adj.

CRAM score (OCSE)
Risk category from 0 to 7 (0 = minimum risk)

How to use OECD category and Sovereign assessment

- **Input for the pricing.** Each category establishes the Minimum Premium Rate (MPR) charged by ECAs to insure sovereign risks (floor).
  MPR is not applied to category 0 countries.

- **Internal evaluation process.** Countries at the highest risk level (cat 7) are regularly monitored (monthly update of country report, review of terms of cover).

- **Limit on exposure**. Countries at the highest risk level (cat 7) usually have country ceiling (limit to total exposure in the country).

OECD Classification “Better than Sovereign”

Better than Sovereign (SOV+)

It could happen that the sovereign is not the best buyer in a given country and the risk distance between the sovereign and best buyer is sufficiently large

“The entity achieving such a classification is one with an exceptionally strong credit profile which could be expected to fulfil its payment obligations during a period of sovereign debt distress or even default”

In the countries where the sovereign has been “flagged” it will be possible to use the BTS buyer risk category (with a premium that is 90% of the SOV rates) without needing to have the entity rated better than the sovereign by a rating agency.

OECD Classification “Better than Sovereign”

When country risk is better than sovereign risk?

Identify sovereigns whose credit risk could be lower than country risk:

- Monetary union or special monetary arrangement
- Weak public finances
- Critic payment experience

Better than Sovereign (SOV+)

“The entity achieving such a classification is one with an exceptionally strong credit profile which could be expected to fulfill its payment obligations during a period of sovereign debt distress or even default”

In the countries where the sovereign has been “flagged” it will be possible to use the BTS buyer risk category (with a premium that is 90% of the SOV rates) without needing to have the entity rated better than the sovereign by a rating agency.

How to be classified as SOV+?

In order to be classified as better than sovereign, an entity would be expected to display several of the following characteristics:

- A strong **credit profile**;
- substantial **foreign exchange earnings** relative to its currency debt burden;
- production facilities and cash generation ability from **subsidiaries or operations offshore**, especially those domiciled in highly rated sovereigns, i.e. multinational enterprises;
- a **foreign owner or a strategic partner** which could be relied on as a source of financial support in the absence of a formal guarantee;
- a **history of preferential treatment** of the entity by the sovereign, including exemption from transfer and convertibility constraints and surrender requirements for export proceeds, and favourable tax treatment;
- **committed credit lines from highly rated international banks**, especially credit lines without a material adverse change (MAC) clause which enable banks to withdraw committed facilities in the event of a sovereign crisis or other risk events; and
- **assets held offshore**, especially liquid assets, often as a result of rules allowing exporters to trap and maintain cash balances offshore that are available for debt service.

Countries SOV+

CFA West Africa	CFA Central Africa	Others
Benin	Cameroon	Antigua and Barbuda (ECCU)
Burkina Faso	Central African Republic	El Salvador (USD)
Guinea-Bissau	Chad	Panama (USD)
Ivory Coast	Congo	
Mali	Equatorial Guinea	
Niger	Gabon	
Senegal		
Togo		

Country and Sovereign Risk Analysis

Risks and Solutions for Clients

According to the wisdom of A. Hirschman, "*each project comes into the world accompanied by two sets of partially or wholly offsetting potential developments: i) a set of possible and unsuspected threats to its profitability and existence; and ii) a set of remedial actions that can be taken should a threat become real*." The answer to this uncertainty is creativity that "*always comes as a surprise to us*".

Hirschman A., Development Projects Observed, Brookings Institution Press (1967).

The aim of this new approach is to associate those risks with domestic agents based on the business they normally undertake abroad, identifying the most relevant insurance and financial products that an Export Credit Agency like SACE provides.

Introduction to SACE methodology

The concept of country risk is **not easily quantifiable** and the **difficulty of its measurement** is compounded by the numerous steps involved:

i) the identification of the sources of risk;

ii) the extrapolation of the risk-event unfolding process;

iii) the estimate of the impact on a specific transaction/economic agent;

iv) the means/actions undertaken to mitigate the impact before and after the event has occurred.

This presentation is based on the premise that there is no single country risk and that every economic transaction/agent faces a specific set of country risks.

Country risk is like beauty

Country risk depends on the **interaction of complex financial, economic, social and political variables**. To condense all these variables into a single country risk index is not only impossible, but probably **misleading**.

To understand country risk, there is no alternative other than a detailed and specific analysis.

In the end, **risk is like beauty: it lays in the eyes of the beholder**. This approach proposes that every economic agent (i.e., exporters, banks, contractors, and investors) could face different risks depending from the kind of investment.

SACE risk index

0 › 10	11 › 20	21 › 30		**Low risk**
31 › 40	41 › 50	51 › 60	61 › 70	**Medium risk**
71 › 80	81 › 90	91 › 100		**High risk**

Country Risk: the new SACE approach

Country Risk

Entrepreneur

- **Exporter**
- **Bank**
- **Builder**
- **Investor**

Risks

- **Credit (Counterpart risk)**
  - Sovereign
  - Bank
  - Corporate
- **Regulatory risk**
  - Expropriation and Nationalisation
  - Transfer and convertibility
  - *Breach of contract*
- **Political violence risk**

Protection tools

- **Supplier Credit**
- **Buyer Credit/**
  - Confirmation of Documentary letters of credit
- **Construction Risk**
- **Guarantees**
- ***Political Risk Insurance***

Credit Risk and methodology to assess it

Credit risk is the risk that a foreign counterpart fails to meet its contractual obligations. The nature of the counterpart involved in the transaction (i.e. sovereign, banking, corporate) is key to the credit risk analysis and is at the core of the credit risk assessment.

The counterpart's ability to fulfil its financial obligations depends not only on its creditworthiness or "economic health", but also on national and international factors that may eventually affect its ability to pay.

"Willingness to pay" depends on the counterpart's credit history, which in turn is assessed by considering the counterpart's track record of payments. Domestic or international tensions (on-going or potential) potentially affect its "ability to pay" of fulfil any contractual obligation.

Regulatory risk and methodology to assess it

Regulatory risk is the risk of losses for foreign economic agents resulting from discriminatory actions undertaken by a local government. This risk arises when a government adopts laws or regulations that either directly or indirectly:

- ✓ Deny foreign agents of ownership or control of assets held in that country (risk of expropriation, whether direct or creeping, confiscation, nationalisation)
- ✓ Unilaterally alter or breach contractual obligations undertaken by the government or public entities with the investor (breach of contract risk);
- ✓ Prevent the foreign agent from converting or repatriating the assets or their cash-flow (transfer and convertibility risk).

Regulatory risk assessment must include the analysis of the political and operational context of the foreign country, as well as its economic and financial standings.

Example: Creeping Expropriation in Russia

- The second phase of Sakhalin project, a PSA (Production Sharing Agreement) with Royal Dutch Shell in Siberia, has been halted by the Russian government owing to environmental issue.
- The revoke of environment permits persuaded Shell to renegotiate the terms of agreement (after energy prices had greatly increased) and hand over the control of the project to the Russian state-owned gas company.

Example: CADIVI in Venezuela

- In December 2002 and January 2003 workers' strikes considerably affected the Venezuelan oil sector, the country's main source of hard currency.
- In order to avoid international reserve depletion and further outflows of foreign capitals, President Chavez established a Commission for the Administration of Foreign Exchange (CADIVI), in charge of the regulation of the sale and purchase of foreign currency.
- Since then, transfer restrictions have been introduced and foreign corporates operating in the country and are now requested to secure CADIVI authorization before repatriating dividends and capital.
- In the last years restrictions have tightened and governmental authorizations severely decreased (to USD 61.1 million in 2010 from USD 3.8 billion in 2007).

Political violence risk and methodology to assess it

Political violence risk is the risk of violent episodes leading to losses of assets or income for a foreign agent. This risk stems from political events and may lead to physical damage and/or financial losses.

Political violence risk is assessed on the basis of social or institutional weaknesses in the country, such as the existence of internal or external disputes/conflicts, the degree of accountability and stability of the government.

All economic agents – domestic and foreign - operating in a country are potentially exposed to this risk to a degree that varies with the location of the business, the strategic relevance of the sector, and the visibility of the assets.

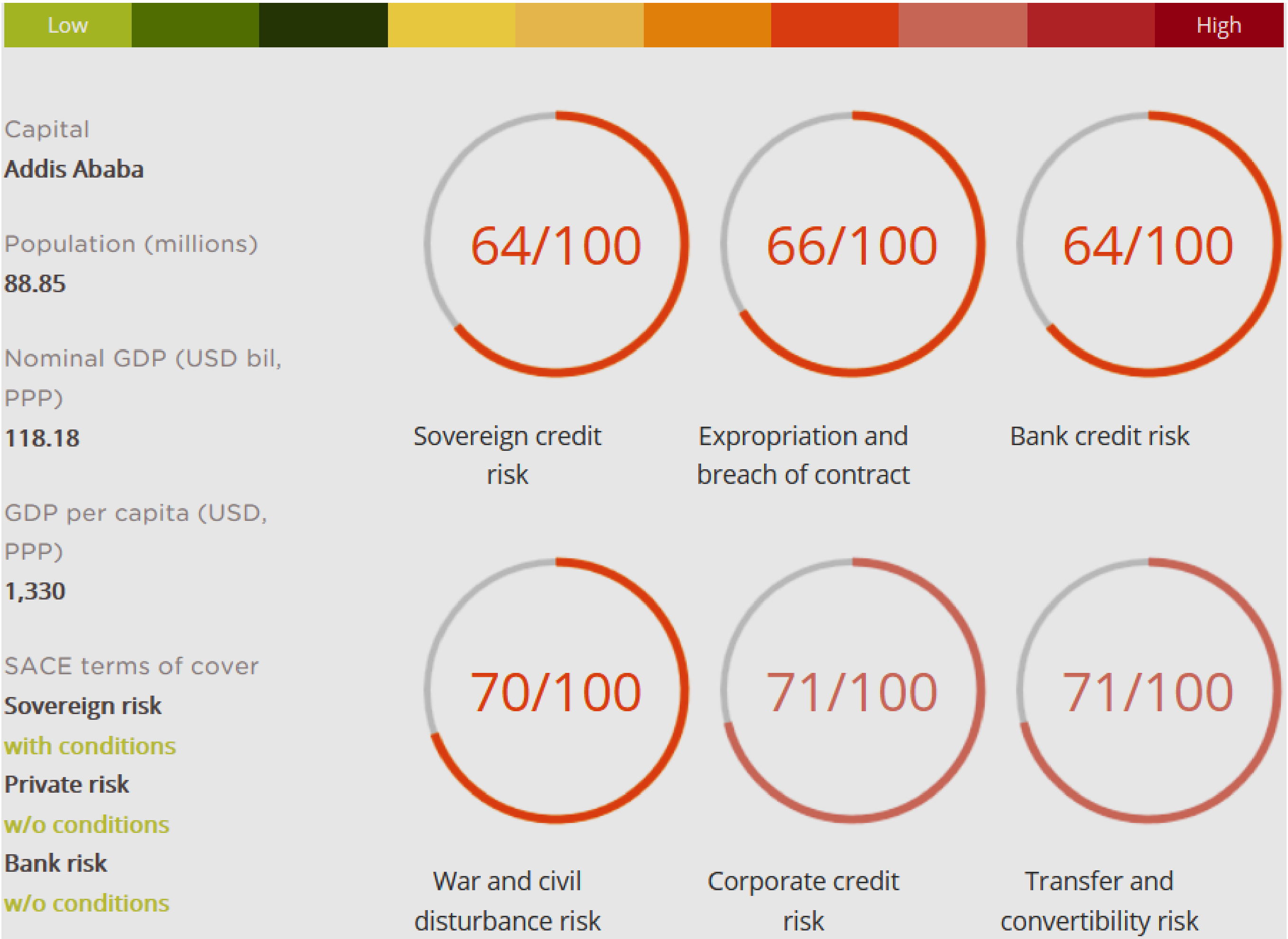
Example: 2011 Arab Spring

- Challenging economic issues (namely, high youth unemployment, income inequality and rising food inflation) and lack of political rights exacerbated the social tensions and ignited violent clashes in North Africa and the Middle East (mainly in Bahrain, Egypt, Libya and Tunisia).

- Fighting and mass demonstration caused disruption of business activities, damages and destruction of local commercial and industrial structures.

- The uncertain transitional process, the decline of security situation, the ongoing social tensions and the consequent slowdown in economic activity still pose challenges to local and foreign business.

Example: Banking risk in Ethiopia



Capital
Addis Ababa

Population (millions)
88.85

Nominal GDP (USD bil, PPP)
118.18

GDP per capita (USD, PPP)
1,330

SACE terms of cover
Sovereign risk
with conditions
Private risk
w/o conditions
Bank risk
w/o conditions

OECD Country Risk Category
7

Insurance terms of cover

Since March 2010 SACE has adopted the following insurance terms of cover:

Without conditions	No restrictions to SACE's activity
With conditions	SACE's activity is subject to some restrictions deriving from international agreements (i.e. IMF Programs' conditionality requirements, and/or OECD's sustainable lending principles)
Case by case	SACE's activity on credit risk is limited to transactions with substantial risk mitigating factors (structured finance or project finance transactions, transactions partly financed by IFIs, regional development bank or other ECAs). PRI and non-credit risks are also available.
Off cover	No cover is available due to the persistent default in the country and/or lack of safety business conditions.

Five step analytic process

Economic Agent → **Purpose** → **Payback** → **Risks** → **Structure**

Economic Agent

Who is international actor?

Purpose

Who is the borrower or counterparty?

For what purpose are the lines or funds are being used?

Payback

Sources of payback

- Refinance
- Sale of assets
- External package
- Cash flow

Risks

Assess the creditworthiness of the borrower or counterparty and likelihood of transfer risk or other political risks

Structure

Evaluate the transaction risks and reward and possible mitigants

Ability vs. Willigness to pay

Country	Venezuela
Year	2013
Risk	Buyer Credit
Project	Turbines for extraction plants and maintenance
Debtor	Oil Company
SACE Facility	EUR 20.000.000
Percentage of cover	80% Commercial and political
Tenor	12m

Case study: Egypt

Critical factors:

- ✓ Political uncertainties have weighed on both tourism and capital flows, leading to a decline in reserves from 6.8 months of imports in mid-2010 to 2½ months of imports in December 2014
- ✓ Central Bank adopted measures in order to limit the level of deposits denominated in forex
- ✓ Imposed strick requirements for opening LC for importing good/equipments from aboard (100% cash collateral)
- ✓ Less availability of hard currency for banks and delays for converting local currency (especially for non-strategic importers)

Country	Egypt
Year	2016
Product	Supplier's Credit Policy
Supply	Equipment for water treatment
Debtor	JV Egypt (52%) – USA (48%)
Contract Amount	Euro 222.000
SACE Cover	Euro 222.000
Percentage of cover	100% commercial and political
Tenor	8m
Mitigant	Longer waiting period: 120 days

Case study: Tunisia

Country	Tunisia	Tunisia
Year	Dec 2015	Jan 2016
Product	Civil Works Policy	Civil Works Policy
Supply	Highway construction (portion)	Pipeline
Buyer	1) Ministere de l'Equipment, de l'Habitat et de l'Amenagement du Territoire 2) Tunisie Autoroutes	JV Tunisia/Germany
Contract Amount	Euro 37,700,000	Euro 2,900,000
SACE Cover	Euro 750,000 (industrial vehicles)	500,000 (industrial vehicles) + 500,000 (costs)
Percentage of cover	95% political	100% political
Tenor	1 year and 11 months	10 months
Location	Kettana e Mareth / Echangeur Ezzouhour in Tunisi	Nawara-Gabes

Tunisia map


Mediterranean Sea
La Galit
Cap Blanc
Bizerte
Menzel Bourguiba
Gulf of Tunis
Cap Bon
Strait of Sicily
ITALY
Sicily
Marsala
Agrigento
Pantelleria (ITALY)
Tabarka
Béja
Ariana
Tunis
Ben Arous
Jendouba
Nabeul
Zaghouan
Golfe de Hammamet
Le Kef
Siliana
Sousse
Monastir
Moknine
Mahdia
Kairouan
Thala
El Djem
ISOLE PELAGIE (ITALY)
Isola di Lampedusa
Kasserine
Sidi Bou Zid
Sfax
ÎLES KERKENNAH
Mediterranean Sea
Maharès
Gafsa
Skhira
Gulf of Gabes
Chott el Fedjadj
El Hamma
Gabes
Île de Djerba
Houmt Souk
Bahiret el Bou Grara
Nefta
Tozeur
Chott Djerid
Kebili
Matmata
Zarzis
Medenine
Sabkhat al Milh
Tataouine
Zuwārah
Tripoli
Al Jumayl
Az Zāwiyah
Al 'Azīzīyah
Remada
Dhibat
Gharyān
Nālūt
El Borma
Oued Djeneien
Mizdah
Wādī Shurshuf
LIBYA
Ghadāmis
Dirj
ALGERIA
Jijel
Skikda
Annaba
Mila
Guelma
Constantine
Souk Ahras
Aïn M'lila
Batna
Aïn Beïda
Khenchela
Tébessa
Biskra
Bir el Ater
Chott Melrhir
Chott Rharsa
Chott Merouane
El Oued
Touggourt
Tunisia
International boundary
Governorate boundary
National capital
Governorate capital
Railroad
Road
Governorates have the same names as their capitals.
0 50 100 Kilometers
0 50 100 Miles
Base 801544 (B01053) 12-90

Country and Sovereign Risk Analysis

General Overview

Definition of Political Risk Events & Covered Risks: from due diligence to recovery after compensation:

- Covered Risk
- Compensation
- Recovery after compensation

Risk Assessment: from a Country to a Project Level

Political Risks: Events of default

Risks	Events of default
Expropriation	Any discriminatory action by the host government which deprives or prevents the Guarantee Holder from exercising its ownership rights in, or effective control of the guaranteed investment
Transfer and convertibility	Any action by the host government which prevents, directly or indirectly, the Guarantee Holder from legally converting or transferring outside of the host the dividends, profits or other monetary benefits/returns derived from the investment
Political violence	Any political disorder or turmoil or conflict which can cause: i) destruction or disappearance of, or physical damage to, tangible assets in the host country functional to the investment project; ii) total inability of the project enterprise to conduct operations essential to its overall financial viability as a going concern for the duration of the applicable waiting period; iii) business interruption.
Breach of Contract	Contracting party’s actual failure or refusal to perform (or a clear indication of its intentions to not perform) its obligations under the contract.

Expropriation: Covered Risks

✓ **Equity coverage**. Protects against losses due to any action by the host government which:

1. deprives or prevents the Guarantee Holder from exercising its ownership rights in, or effective control of the guaranteed investment; or
2. deprives the Guarantee Holder of a fundamental right essential to the overall financial viability of the guaranteed investment.

➢ **Provided** that:

1. there is a direct and immediate causality between the event and the losses;
2. the action/event is discriminatory and arbitrary (or it has a confiscatory effect);
3. such losses continue for the duration of the applicable waiting period.

✓ **Credit coverage.** Covers the inability to repay of the debtor caused directly and immediately by an expropriation event provided the discriminatory and arbitrary nature of it.

➢ **The event itself does not necessarily lead to a claim since the host government could continue honoring company's payment obligations.**

Expropriation: Compensation and Recovery

- **Equity coverage.** Compensation payable includes:

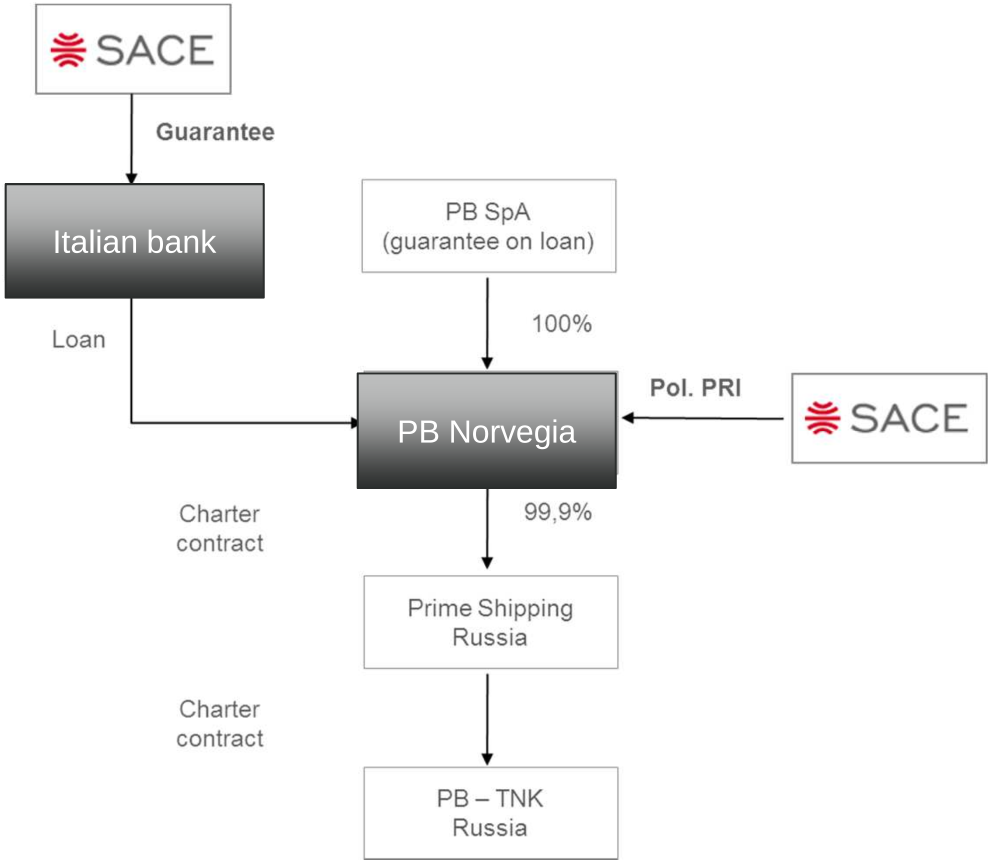
  i. the net book value of the project enterprise (also the goodwill value); or

  ii. the book value of any confiscated tangible assets.

- **Credit coverage**. Compensation payable includes the due amount and unpaid principal and interest amounts.

- **Recovery after compensation**. Both for equity and credit risk coverage compensation is not eligible to Paris Club negotiation and it can only be recovered on a bilateral basis. PRI providers failing to recover directly from the host government can bring the dispute to the International Centre for Settlement of Investment Disputes (**ICSID**).

Case study: PB SpA



Country	Russia
Year	2016
Product	Political Risk Insurance
Risk	Expropriation and nationalization, Political violence
Insured	Italian Bank
Beneficiary of the investment	PB Norvegia
Object	Acquisition 14 tankers
Loan amount	USD 107 mln
SACE cover	62,5% loan amount 100% PRI tankers value

Transfer Restrictions: Covered Risks

- ✓ **Equity coverage.** Protects against losses due to any action by the host government which prevents, directly or indirectly, the guarantee holder from legally:

  i. converting into the guaranteed currency the local currency constituting:

    a. dividends, profits or other monetary benefits derived from the investment;
    b. proceeds from the disposal of, or other return of, the guaranteed investment; or
    c. any other return on the guaranteed investment;

  ii. transferring outside of the host country the guaranteed currency

  Provided that the amounts have been deposited in the host country.

- ✓ **Credit coverage**. Covers the **inability to repay** of the debtor **caused directly and immediately** by **the impossibility to convert or transfer** the amounts deposited in the host country.

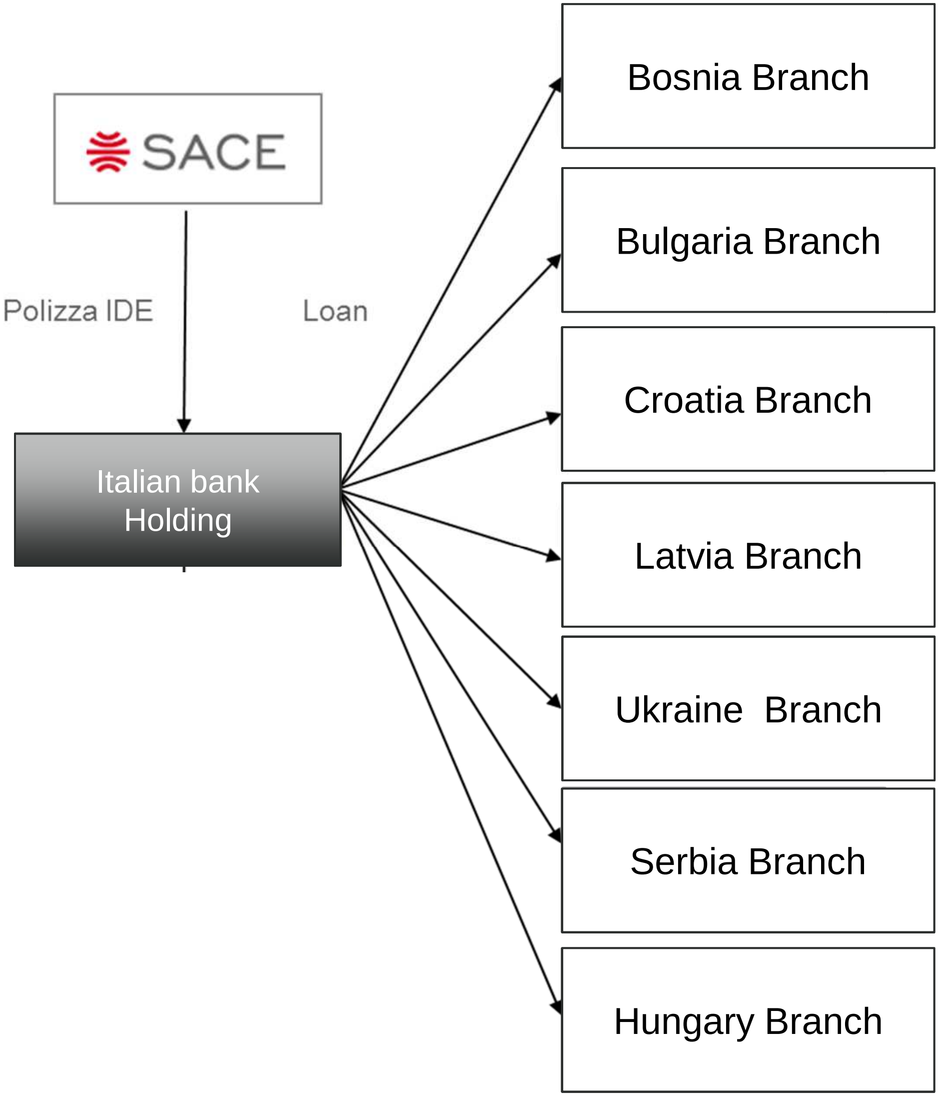
Transfer Restrictions: Compensation and Recovery

- For both **equity** and **credit coverage**, compensation payable includes:
  i. for **inconvertibility**, the guaranteed currency equivalent of the local currency which could not be converted in respect of the guaranteed amount, calculated on the basis of the reference exchange rate on the date of loss;
  ii. for **inability to transfer**, the amount of guaranteed currency that could not be transferred in respect of the guaranteed investment as of the date of loss.

- **Recovery after compensation**. Both for equity and credit risk coverage, PRI providers can face two different scenarios:

  i. no revocation of the transfer restriction measure**.** Recovery of the compensation directly from the host government according to the Paris Club provision**.**
  ii. revocation of the transfer restrictions measure. Recovery of 100% of the compensation paid by converting and transferring the amounts deposited in the host country or only **partial recovery** if a **devaluation/depreciation** of the local currency has occurred. (**For credit risk coverage,** PRI providers have the right to recourse against the borrower as long as the loan agreement provides the obligation fulfilled only if the lender receives 100% of the due amount in the hard currency).

Case study: Intercompany loans cover



Country	Various countries
Year	Various
Product	Political Risk Insurance
Risk	Shareholder's loans to subsidiaries in Eastern Europe
Insured	Italian Bank Holding
Beneficiary of the investment	Italian Banks CEE
Object	Liquidity support
Loan amount	EUR 800 mln
SACE cover	PRI policy, covering 100% of the loans' principal amount
Tenor	Various

War and Civil Disturbance: Covered Risks

- ✓ **Equity coverage.** Protects against losses due to:

  i. destruction or disappearance of, or physical damage to, tangible assets in the host country functional to the investment project;

  ii. total inability of the project enterprise to conduct operations essential to its overall financial viability as a going concern for the duration of the applicable waiting period;

  iii. business interruption**.** Few insurers (e.g. MIGA) offer coverage against the temporary but complete suspension or interruption of the operation of the investment project due to loss of assets or unreasonably hazardous conditions resulting in the temporary abandonment, evacuation or denial of use of the investment facilities.

  Provided that the **losses** are **direct and immediate** results of acts of war, revolution, insurrection, civil war, riots or acts of **terrorism** (covered only by some PRI providers, e.g. MIGA and private insurers). **Force majeure is not covered**.

- ✓ **Credit coverage**. Covers the **inability to repay** of the debtor **caused directly and immediately** by any political violence event or force majeure (not for shareholders' loans) damaging the investor's assets.

War and Civil Disturbance: Compensation and Recovery

- ✓ **Equity coverage.** Compensation payable is:

  i. in case of loss of assets, (i) **the lesser** between the **replacement cost** of such tangible assets and the **reasonable cost of repair** of them; or (ii) the book value of the affected tangible assets;

  ii. in case of permanent loss of use of the project, the **net book value of the project enterprise** calculated as of the day immediately preceding the date of loss;

  iii. in case of temporary loss of income, the **sum of the lost business income, continuing expenses and extraordinary expenses of the project enterprise** incurred during the indemnification period.

  iv. for business interruption compensation is based upon the **lost business income** calculated taking into account business income before the loss occurred.

- ✓ **Credit coverage**. Compensation is equal to the unpaid amount by the borrower.

- ✓ **Recovery after compensation**. For both equity and credit risk coverage, compensation is **not eligible to Paris Club** and it can **only be recovered on a bilateral basis**.

Case study – Italcompany

Country	Various countries (Saudi Arabia, Egypt, China,India, Morocco etc.)
Year	2014
Product	Political Risk Insurance
Risk	Political violence and expropriation
Insured	Italian Company
Beneficiary of the investment	Italian company's foreign subsidiaries
Object	Production plants
SACE cover	PRI policy, coinsurance with private market
Total amount of the investment	Euro 2.2 bn
Insured amount by the pool (30 insurers)	Total amount insured Euro 800 Mln: • First layer: 500 Mln • Second layer 150 Mln • Third layer 150 Mln
Insured amount by SACE	Euro 55 Mln (11% of first layer) + 55 Euro Mln
Tenor	3 years

Breach of Contract: Covered Risks

- **Equity coverage**. Protects against losses that are:

  i. the direct and immediate result of the inability of the guarantee holder to enforce an award rendered in favor of the insured party against the host government (**Arbitral Award Default**);

  ii. due to **any action** by the host government which makes the invocation, operation or formal conclusion of the dispute resolution procedure either (**Denial of Justice**):

     a. **impossible or unable to be proceeded according to its rules**;

     b. **exceptionally hazardous**;

     c. **commercially impracticable**.

- **Credit coverage**. Standard credit risk policies covering against political risks do not include Breach of Contract. **BoC coverage appears as an add-on including the risk of a shortfall in the cash-flow of the borrower caused solely and directly by the lack of performance of public buyer.**

Breach of Contract: Compensation and Recovery

- **Equity coverage.**
  i. Arbitral Award Default: compensation shall be computed as guarantee holder's share of the award payable in guaranteed currency as of the date of loss;

  ii. Denial of Justice: compensation is payable prior to the issuance of an award in an amount not exceeding the lesser of: (a) the amount determined to be due by the host government to the guarantee holder and (b) the outstanding amount of the guarantee.

- **Credit coverage**. Compensation is equal to the unpaid amount by the public borrower according to the rendered award provision (Award Arbitration Default) or the lesser of (a) and (b) above (Denial of Justice).

- **No compensation shall be payable** for any loss under BoC suffered by: (i) a State-Owned Enterprise or public authority which, on the date of loss, is no longer under supervision or control of a governing authority; (ii) a public or regulatory authority for whose obligations the governing authority is no longer liable on the date of loss (**privatization event**).

- **Recovery after compensation**. For both equity and credit risk coverage, compensation is **not eligible to Paris Club** and it can **only be recovered on a bilateral basis**.

Risk Assessment: from a country to a project level

✓ Generally speaking, the country-level analysis deals with three main dimensions:

i. **Economic Fundamentals,** specifically the **quality of macroeconomic management** and the **resilience to adverse shocks;**

ii. **Political System,** in terms of both **legitimacy** and **"interventionism"** in the economic activity;

iii. **Legal System**, based on the integrity of the judicial system and the insurance track record in the country, including claims' history.

✓ Most of PRI providers (among them SACE and MIGA) set up an internal scoring system, through a methodology combining qualitative and quantitative analyses, usually conceived by single risk.

✓ The outcome is a score giving a view on the relative likelihood of a claim occurring per type of risk over the medium term (3-5 years). The country risk score may be upgraded or downgraded on a project level according to the main features of the investment project.

➢ SACE scoring system envisages the possibility to upgrade/downgrade country risk score from one to three notches according to investment project features.

Risk Assessment: Expropriation/Breach of Contract

Country Level

- ✓ **Government/opposition general attitude** towards foreign investment (**BITs**);
- ✓ Degree of **legal protection** of the investment project under domestic law;
- ✓ **Vulnerability to terms of trade shock** (i.e. Venezuela);
- ✓ **Institutional permanence** (system of check and balances);
- ✓ **Degree of representativeness** in the political system;
- ✓ **Political** and **economic instability**;
- ✓ Features of **judicial system**.
- ➢ Last 4 factors highlighting **political constraints**, **level of democracy** and **checks on government** have a great impact on expropriation risk level.

Project Level

- ✓ **Type (equity/non equity)** and **size** of the investment project in comparison to host country's GDP;
- ✓ **Sector** (oil&gas, mining, public utilities, natural resources, manufacturing), importance and size of the sector for the host economy;
- ✓ **Relation with state-owned enterprises**;
- ✓ Contribution to the host economy, especially in terms of **generation of revenues and import substitution**;
- ✓ Economic viability and foreign currency earnings;
- ✓ **Exposure to the host government regulation**;
- ✓ **Ownership and control**;
- ✓ **Joint venture partners** (public or private);
- ✓ Host country's ability to compensate

Risk Assessment: Transfer Restrictions

Country Level

- ✓ **Exchange control regime** (evolution over time and perspective changes);
- ✓ **Liquidity position** (and its likely development over the period of the guarantee: (i) **Balance of payments**; (ii) **Foreign exchange reserves**; (iii) **General payment record on foreign debt**;
- ✓ **Outward-oriented nature** of economic policies;
- ✓ **Import dependency**;
- ✓ **Debt service ratio;**
- ✓ **Vulnerability to terms of trade shocks**;
- ✓ **Transfer and convertibility delay experience**;
- ✓ **Potential of recovery and salvage risk**.
- ➢ SACE relies on OECD categories because of the high correlation between economic situation and transfer restriction risks.

Project Level

- ✓ **Type of investor's return on investment** (e.g. dividends, share in profits, revenues or production volumes, fixed royalties or fees);
- ✓ **Amounts of expected transfers** and time schedule (relative also to host country's foreign exchange position);
- ✓ **Use of offshore accounts**;
- ✓ **Import substitution effect**;
- ✓ **Shareholders and long term creditors**, especially participation of local partners, public domestic institutions (ECAs or international organizations);
- ✓ **Foreign exchange earning potential**;

Risk Assessment: War and Civil Disturbance

Country Level

- ✓ **Internal and external political consensus**;
- ✓ **External aggression**, i.e. the likelihood of armed conflict with another country, existing insurgency, revolution or violent opposition;
- ✓ **Existence of armed conflict** outside the host country which might affect the investment project's viability;
- ✓ Level of **representativeness** of the population;
- ✓ **Ethnic, social, religious divisions**;
- ✓ **Political and economic instability** (economic crisis, level of unemployment);
- ✓ Features of the **judicial system** (independence, predictability and efficiency).

Project Level

- ✓ **Type of investment** (equity/non equity) as well as **tangible/intangible assets**;
- ✓ **Strategic significance** to both host government and its potential rivals (military and politically importance);
- ✓ **Geographic location** with respect to areas of hostilities;
- ✓ **Vulnerability to damage and reliance on critical transportation links** or raw material supply or energy sources;
- ✓ **Mobility of assets**;
- ✓ **Security arrangements** in place.

Country and Sovereign Risk Analysis

Countries never go bankrupt

The most charismatic and influential banker of the 1970s, Citibank's Chairman, Walter Wriston, famously declared that "**countries never go bankrupt**".

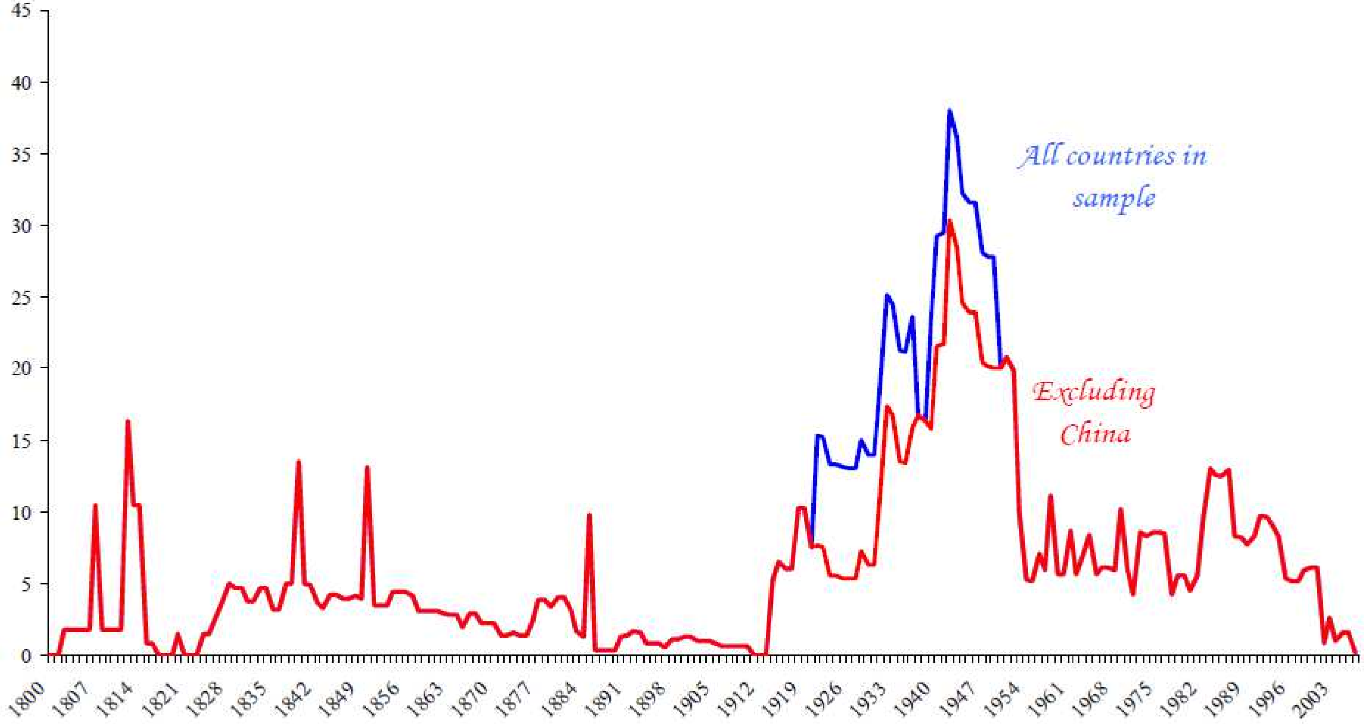
His argument was that:

"Countries *don't go bankrupt ... the infrastructure doesn't go away, the productivity of the people doesn't go away, the natural resources don't go away. And so their assets always exceed their liabilities, which is the technical reason for bankruptcy. And that's very different from a company*."

Source: Wriston, Walter B. "Was I exacting? Sure. Was I occasionally sarcastic? Of course." Institutional Investor 21, no. 6 (June 1987) 16(5),

Sovereign External Debt default in History

Sovereign External Debt: 1800-2006 Countries in Default Weighted by their share of world income

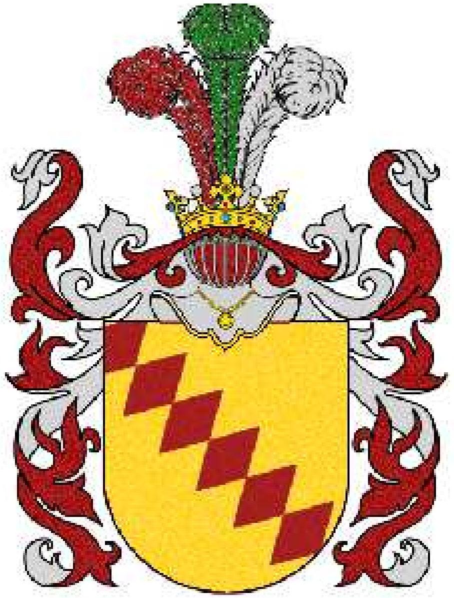


Source: C. Reinhart and K. Rogoff (2011), This Time Is Different: Eight Centuries of Financial Folly.

Carmen Reinhart and Kenneth Rogoff count 250 defaults on government external debt and 68 on government domestic debt from 1800 to the early 2000s

History of bubbles and defaults

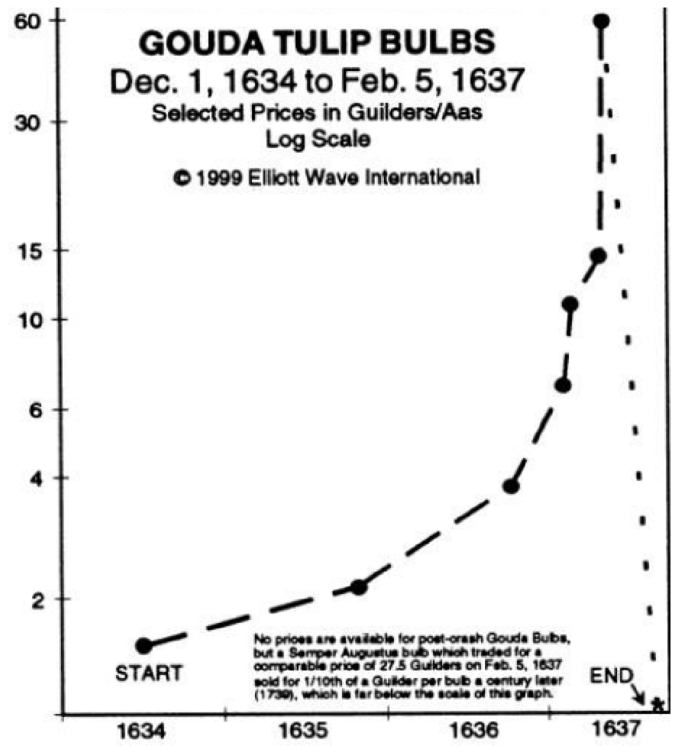
The first recorded default in Greek history occurred in the fourth century B.C., when 13 Greek city states borrowed funds from the Temple of Delos. Most of the borrowers never made good on the loans and the temple took an 80% loss on its principal.



The **first sovereign default in History**. During the Hundred Years War in the early 1340s, Edward III of England was engaged in an expensive war with France. He borrowed 600,000 gold florins from the Peruzzi banking family and another 900,000 from the Bardi family. In 1345 Edward III defaulted on his payments, causing both banking families to go bankrupt.

History of bubbles and defaults

The **Tulip mania**: the first speculative bubble. Tulip mania was a period in the Dutch Golden Age (17th century) during which contract prices for bulbs of the recently introduced tulip reached extraordinarily high levels and then suddenly collapsed. At the peak of tulip mania, in March 1637, some single tulip bulbs sold for more than 10 times the annual income of a skilled craftsman.

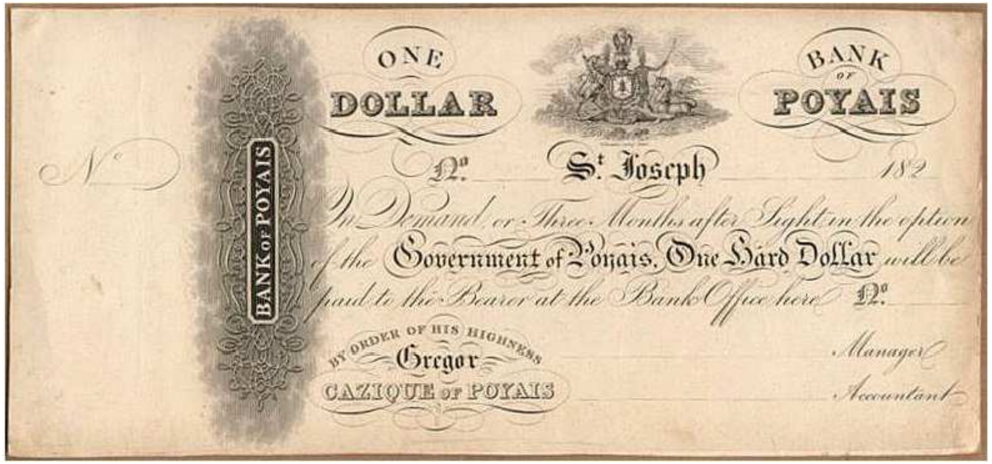


History of bubbles and defaults

South sea bubble. The South Sea Company was a British joint-stock company founded in 1711, created as a public–private partnership to consolidate and reduce the cost of national debt. The company was also granted a monopoly to trade with South America, hence its name. At the time it was created, Britain was involved in the War of the Spanish Succession and Spain controlled South America. There was no realistic prospect that trade would take place and the company never realized any significant profit from its monopoly. Company stock rose greatly in value as it expanded its operations dealing in government debt, peaking in 1720 before collapsing to little above its original flotation price.

History of bubbles and defaults

McGregor and the **Principality of Poyais.** Gregor McGregor was a Scottish soldier, adventurer, land speculator, and colonizer who fought in the South American struggle for independence. After his return to Britain in 1820, he claimed to be prince of the Principality of Poyais, a fictional Central American country that McGregor had invented which, with his promotional efforts, drew investors and eventually colonists.



Russian default in 1917. Bolsheviks, after the revolution, decided to assume no responsibility for, and so default on, Imperial Russia's massive foreign loans. When Russia decide to come back to international market, 69 years later, it had to provide a symbolic indemnification.

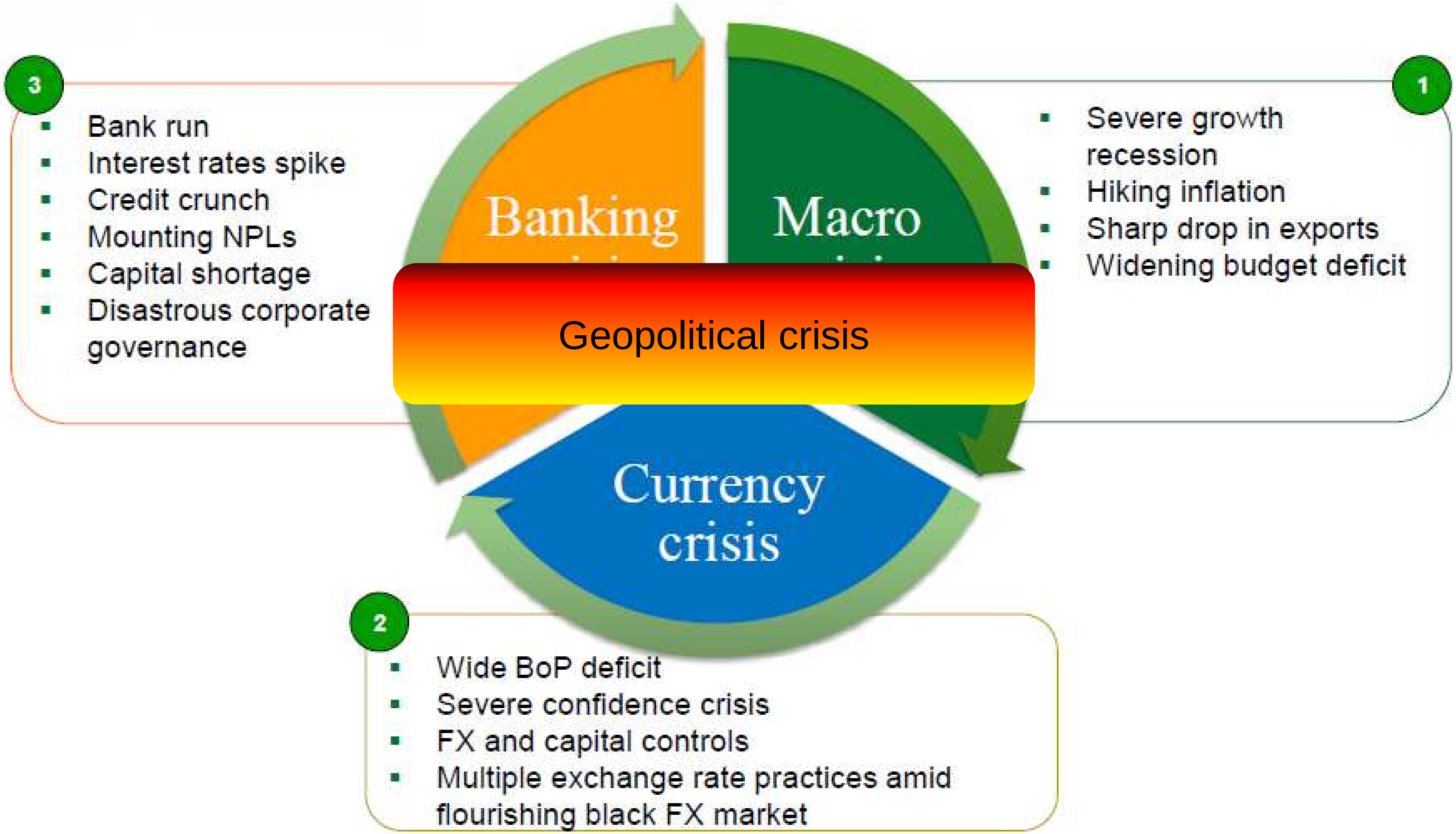
Sovereign Crises in EM (1995-sept – 2008)

Emerging Market Country	Systemic Banking Crises	Currency Crises	Sovereign Debt Crises
Argentina	1995, 2001-2002	2002	2001-2002
Brazil	1994-1995	1999, 2002	
Bulgaria	1996	1996	
Chile			
China	1998		
Colombia	1998		
Czech Republic	1996		
Dominican Republic	2003	2003	2003
Egypt			
Hungary	1991-1995		
India			
Indonesia	1997-2001	1998	1998, 2000, 2002
Israel			
Korea	1997-2000	1998	
Malaysia	1997-2000	1998	
Mexico	1994-1995	1995	
Panama			
Philippines	1997-1999	1998	
Poland			
Russia	1998-1999	1998	1998-1999
South Africa			
Taiwan	1997-1998		
Thailand	1997-2000	1998	
Turkey	2000-2001	1996, 2001	1999
Ukraine	1998	1998	1998, 2000
Uruguay	2002-2003	2002	2003
Venezuela	1994-1995	2002	1998

SACE

Source: "Emerging Market Corporate and Sub Sovereign defaults and Sovereign Crises: Perspective on Country Risk", Feb 2009, Moody's Investor Service

Ukraine: a perfect case history…unfortunately



Country and Sovereign Risk Analysis

How to evaluate a public counterpart

Sovereign Risk:

A risk designed as **Sovereign** is when the obligor (or guarantor) is mandated to enter in a debt payment obligation and commits the full faith and credit of the Sovereign (OECD definition) .

Which are they, then?

- **Ministry of Finance, Central Bank.**
- **Central government entities** provided that the legal due diligence confirms:

  i) the commitment by the State is full faith and credit;

  ii) the credit could be recovered in the framework of Paris Club.

Macroeconomic performance

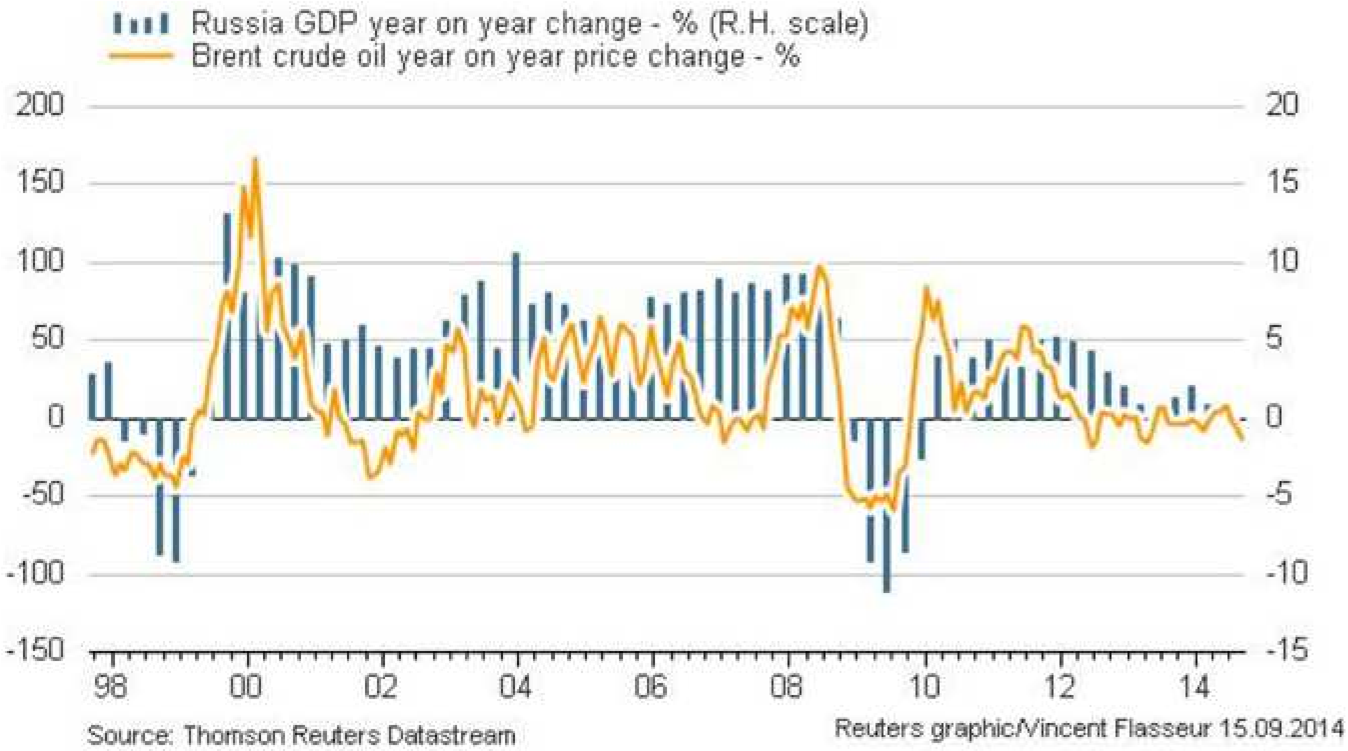
Structured Approach

- **Macro-economic**
  - Domestic economy
  - Policy
- **Public finances**
- **External finances**
- **Social and political factors**
- **Private sector**

- Is the economy growing and robust ?
- Does monetary and FX policy support growth and stability?

The correlation between GDP and the oil price

Russia GDP and Oil price



Macroeconomic performance

Foreign exchange regimes

Dollarization	Adoption of US dollar as the currency of choice
Peg	Policy of controlling the value of a currency by linking it to another currency
Floating	Currency exchange rate which is determined by free market forces rather than fixed by government

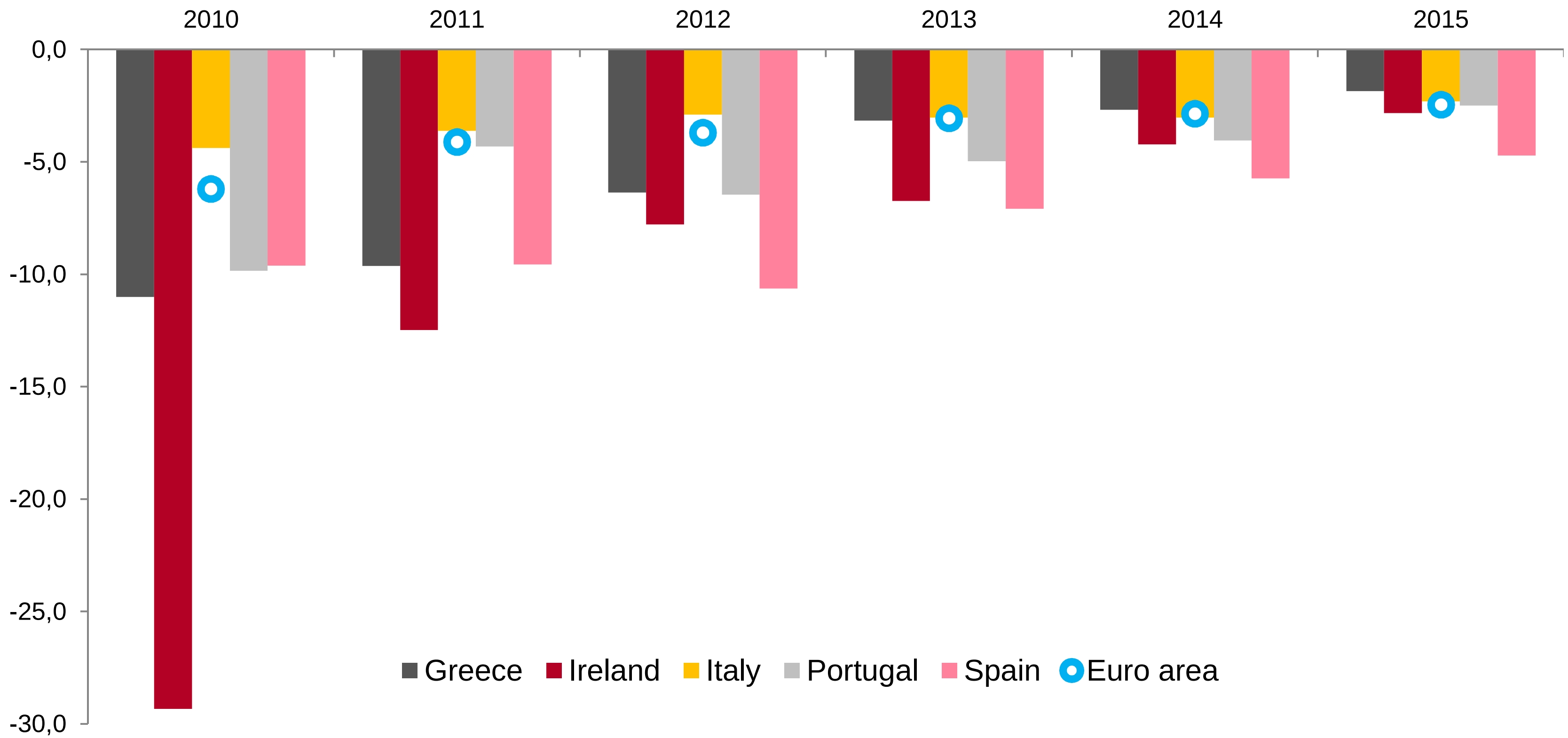
Public Finance

Structured Approach

- **Macro-economic**
  - Domestic economy
  - Policy
- **Public finances**
  - Can the public sector fund itself ?
- **External finances**
- **Social and political factors**
- **Private sector**

Public Finance

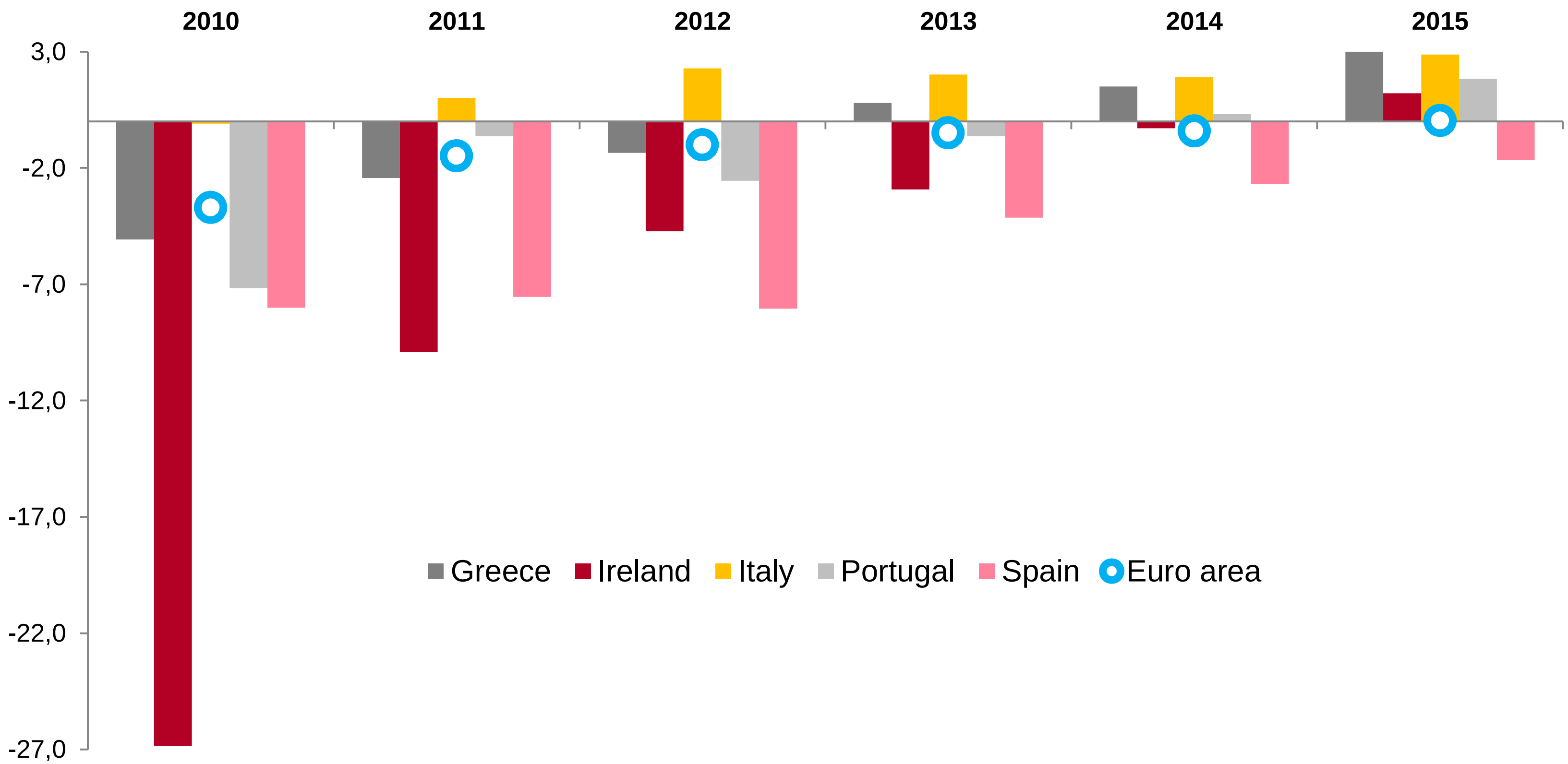
Advanced Economies: General Government Overall Balance (Percent of GDP)



Source: IMF Data, Fiscal monitor 2014.

Public Finance

Advanced Economies: General Government Primary Balance (Percent of GDP)



Source: IMF Data, Fiscal monitor 2014.

Public Finance

Financing Flexibility: key consideration

- Size and maturity of domestic capital market
- Debt breakdown
  - Domestic versus foreign holders
  - Local versus foreign currency
  - Maturity
- Net foreign debt position
- Reserve currency status

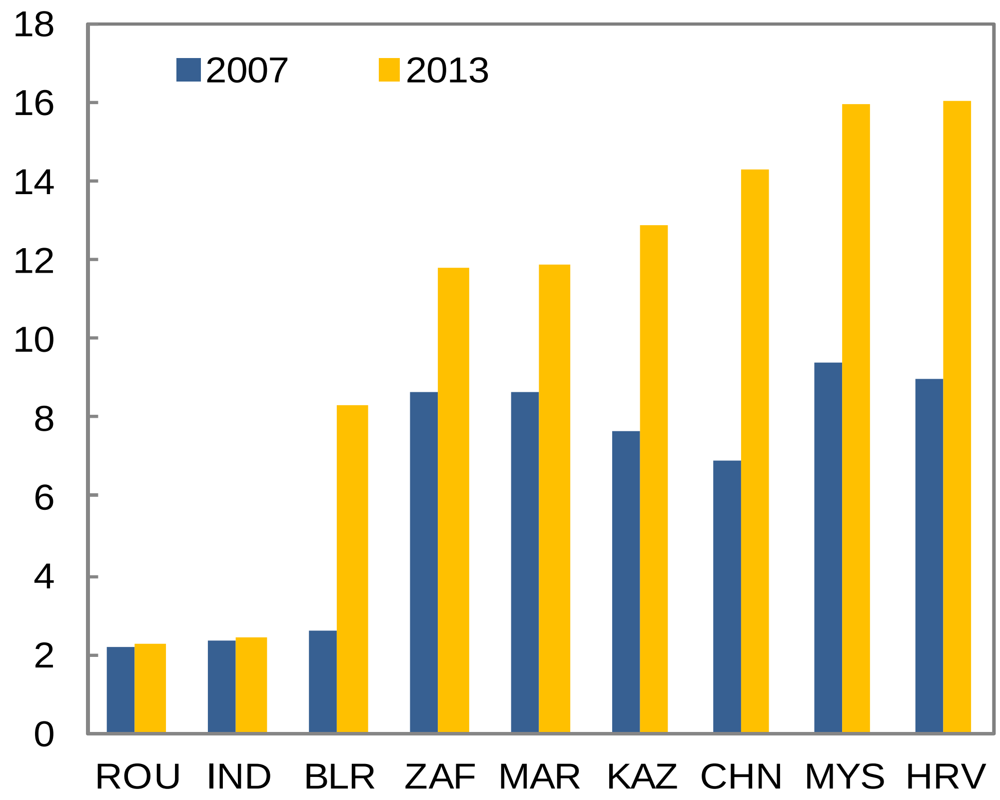
Transaction Ras al Khaiman (EAU)

Buyer's Credit Policy	
Country	Ras al Khaiman (EAU) – Rating A
Risk	Credit risk (political and commercial events)
Insured	International Bank
Exporter	Construction Company
Debtor	Rak Investment Authority
Guarantor	MoF Ras al Khaiman
Purpose of the project	Construction of 12 towers for new financial center
Total amount of the project	USD 550,000,000
SACE facility	USD 250,000,000
Percentage of cover	92,4% (USD 230,900,000)
Tenor	12y door to door (3,5y+9,5y)
Mitigants	- 5,6% not covered by SACE - 2% of each drawdown deposited in a escrow account (cash collateral) - Premium calculated considering a deterioration of the rating (in the hypothesis that the Federal Government will not support Ras al Khaiman)

SACE

Public Finance

Contingent Liabilities (percent of GDP)



Source: IMF Data, Fiscal monitor 2014.

ROU = Romania; IND = India; BLR = Belarus; ZAF = South Africa; MAR = Marocco; KAZ = Kazakhstan; CHN = China; MYS = Malaysia; HRV = Croatia

External Finances

Structured Approach

- **Macro-economic**
  - Domestic economy
  - Policy
- **Public finances**
- **External finances**
  - Can the country self fund its imports?
  - Can the country support its external debt?
- **Social and political factors**
- **Private sector**

Table 6. Mongolia: Balance of Payments, 2011–18 (Strong Policy Scenario)

			Projections				
	2011	2012	2013	2014	2015	2016	2017
	(In millions of U.S. dollars, unless otherwise indicated)						
Current account balance (including official grants)	-2,759	-3,362	-3,470	-2,319	-2,283	-2,855	-2,251
Trade balance	-993	-1,553	-1,425	-267	-19	-435	234
Exports	4,817	4,385	4,193	5,435	6,129	5,987	7,038
Mineral export 1/	4,302	4,032	3,868	5,128	5,807	5,658	6,700
Non-mineral export	515	353	325	307	322	329	338
Imports	-5,810	-5,938	-5,618	-5,702	-6,148	-6,422	-6,804
Oil imports	-1,135	-1,393	-1,430	-1,479	-1,570	-1,668	-1,781
Food imports	-476	-565	-534	-547	-591	-627	-682
For investment in mining 2/	-2,493	-2,627	-1,923	-1,798	-1,874	-1,777	-1,706
Other	-1,706	-1,353	-1,731	-1,878	-2,113	-2,350	-2,636
Services, net	-1,161	-1,100	-1,236	-1,089	-1,135	-1,234	-1,306
Income, net	-843	-948	-956	-1,107	-1,274	-1,332	-1,327
Current transfers	244	237	147	145	145	146	148
General government 3/	24	34	22	19	18	18	19
Other sectors	220	203	125	126	127	128	129
Of which: Workers remittances	58	41	104	104	105	106	106
Capital and financial account	2,864	4,929	1,651	2,456	2,174	3,045	2,475
Capital account	114	120	124	128	132	136	140
Financial account	2,750	4,809	1,527	2,328	2,042	2,910	2,335
Direct investment	4,620	4,408	2,032	1,199	1,437	1,661	1,838
Portfolio investment	77	2,325	634	764	936	947	1,121
Trade credits, net	-406	53	21	-42	-54	-61	-60
Currency and deposits, net	-2,012	-2,473	-2,286	-1,344	-1,229	-1,224	-1,202
Loans, net	469	496	1,273	835	334	986	508
Other, net	2	0	-147	915	619	601	129
Errors and omissions	38	-36	0	0	0	0	0
Overall balance	144	1,531	-1,820	137	-109	191	223
Financing	-144	-1,531	1,820	-137	109	-191	-223
Gross official reserves (- increase)	-140	-1,497	1,912	-76	112	-191	-223
Use of IMF credit (+)	-4	-35	-92	-61	-3	0	0

Social and Political factors

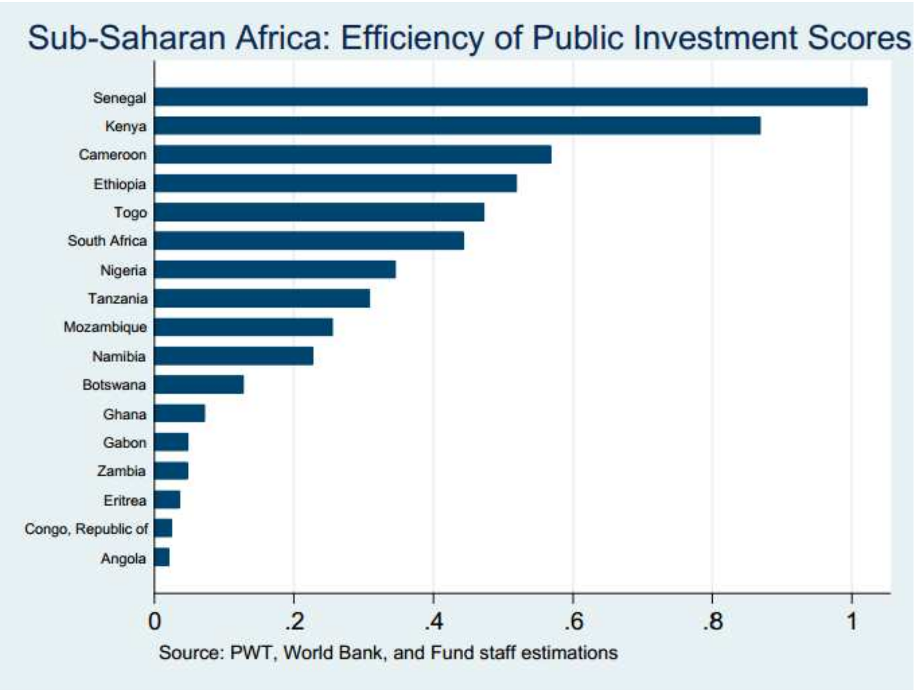
Structured Approach

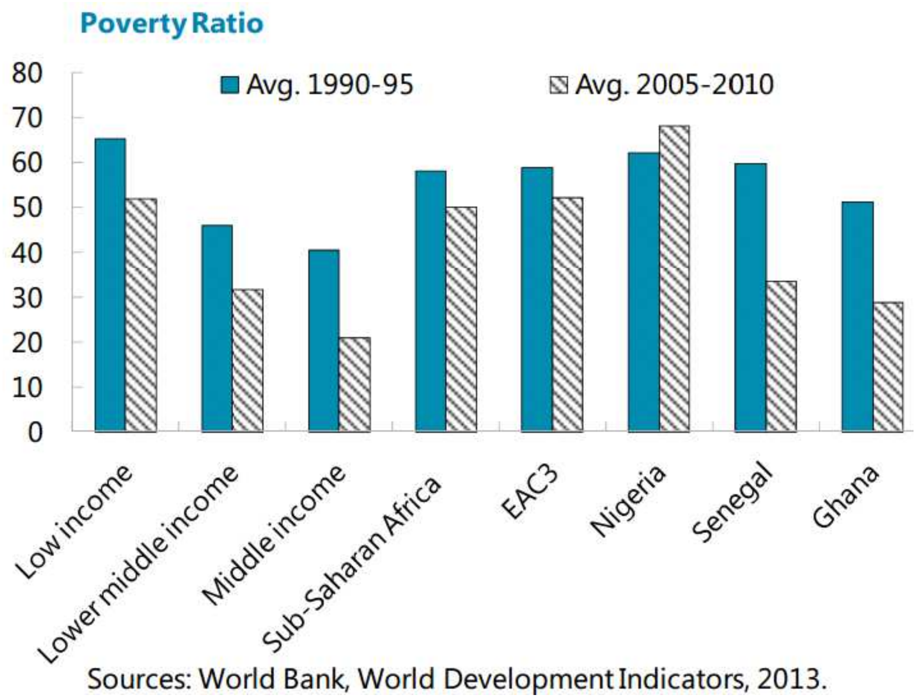
- **Macro-economic**
  - Domestic economy
  - Policy
- **Public finances**
- **External finances**
- **Social and political factors**
  - Is the country stable politically and socially ?
- **Private sector**

Social and Political factors

Social and Political	
Social	Population growth Dependency ratio Unemployment % Education level Wealth distribution (GINI Index)
Political	Rule of law Political stability Government effectiveness Corruption perception index Political rights index Civil liberties index
International position	Membership of political, trade, military groups Strategic importance

Solid Institutions are a key factors

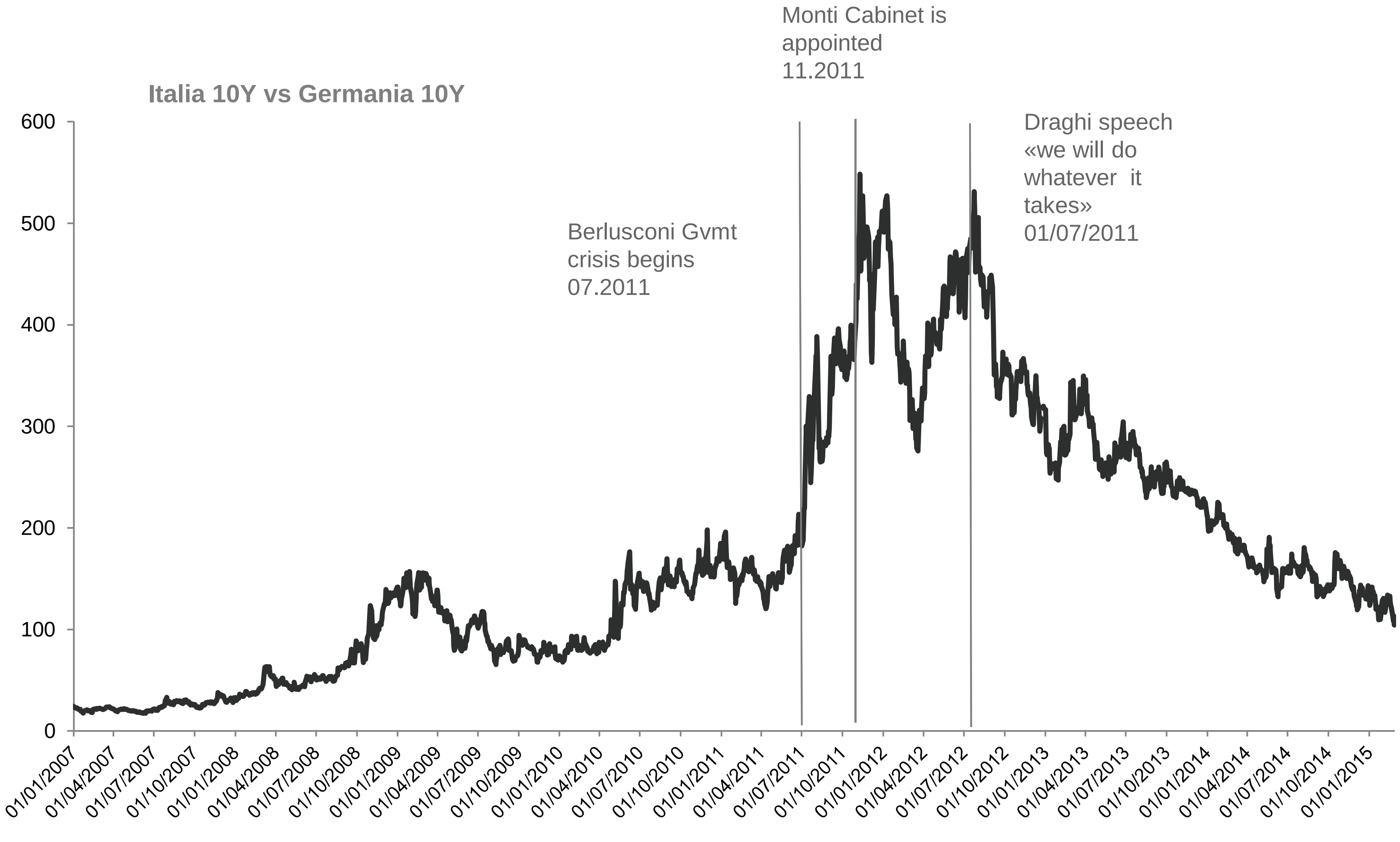




Source: IMF Article IV, Angola

Source: IMF Article IV, Ghana

Spread Italy BTP and German Bund



Source: Bloomberg

SACE

Private sector

Structured Approach

- **Macro-economic**
  - Domestic economy
  - Policy
- **Public finances**
- **External finances**
- **Social and political factors**
- **Private sector**
  - Banking sector
  - Corporate sector

Private sector

Banking sector: key issues

- **Size of banking sector**
  - Total banking sector assets
  - Banking sector penetration
- **Macro prudential indicators**
  - Private sector credit growth
  - Asset price
    - Property market
    - Stock market
- **Funding and financial strength**
  - Individual ratings of banks
  - Funding
    - Loans / deposits
    - Refinancing risk
  - Loss exposure
- **Regulatory support**
  - Support impact on credit worthiness
  - Regulatory response to crisis
  - Cost of regulatory response

Private sector

Corporate sector

- Corporate sector
  - Potential sovereign support: direct or via banks ?
  - Impact on sovereign key performance indicators
  - Impact on Government revenues and banking sector of:
    - Profit declines
    - Default rates
  - Impact on country risk/FX
    - Foreign currency exposure
    - Refinancing exposure

Country and Sovereign Risk Analysis

External support

- **Multilateral**
  - IMF
  - WB and Regional Development Banks e.g. EBRD, IADB

- **Other**
  - Governments
  - Trading partners
  - Members of economic groups: EU, NAFTA, ASEAN
  - Regional central banks

- **Note**:
  - Paris Club: Group of Sovereign Creditors
  - London Club: Group of Bank Creditors

Country crises: defaults and IMF bailouts 1990s

Year	Country	Default	Bail-out
1994	Mexico	**No**	Yes
1997	Korea	Private	Yes
1997	Thailand	Private	Yes
1997	Indonesia	Private	Yes
1997	Malaysia	Capital control	**No**
1998	Russia	**Yes**	Yes
1998	Brazil	No	Yes
1998	Ecuador	**Yes**	Yes
1998	Ukraine	**Yes**	Yes

Source: Fitch Rating

Country crises: defaults and IMF bailouts 1998 -2005

Year	Country	Default	Bail-out
1998	Indonesia	**Yes**	**Yes**
1998	Pakistan	**Yes**	**Yes**
2000	Turkey	**No**	**Yes**
2001	Argentina	**Yes**	**Yes**
2002	Moldova	**Yes**	**Yes**
2002	Brazil	**No**	**Yes**
2003	Uruguay	**Yes**	**Yes**
2005	Dominican Republic	**Yes**	**Yes**

Source: Fitch Rating

IMF Standby Lines in million US dollars Dec 2009

Gabon	May 2007	**120**
Georgia	September 2008	**1,150**
Ukraine	November 2008	**17,000**
Hungary	November 2008	**16,200**
Iceland	November 2008	**2,200**
Pakistan	November 2008	**11,100**
Latvia	December 2008	**2,300**
Belarus	January 2009	**3,500**
Serbia Republic of	January 2009	**4,000**
El Salvador	January 2009	**800**
Armenia	March 2009	**800**
Mongolia	April 2009	**200**

Source: IMF

IMF Standby Lines in million US dollars Dec 2009

Costa Rica	April 2009	**800**
Mexico	April 2009	**48,600**
Guatemala	April 2009	**1000**
Romania	May 2009	**23,800**
Poland	May 2009	**21,000**
Colombia	May 2009	**10,700**
Bosnia	July 2009	**1,600**
Sri Lanka	July 2009	**2,500**
Dominican Republic	November 2009	**1,700**
Angola	November 2009	**1,300**
Maldives	December 2009	**75**
Seychelles	December 2009	**30**

Source: IMF

The Paris Club

- The **Paris Club** is an informal group of official creditors, traces its roots back nearly half a century, to an Argentinean financial crisis in 1956. Argentina met with several of its sovereign creditors in Paris to arrange a rescheduling of its debt payments.

- By meeting to come up with less onerous payment plans, which would typically include at least partial debt forgiveness, creditor nations could ensure that everyone got paid in a timely fashion.

- The Paris Club meets every six weeks at France's Ministry of the economy finance and industry.

- Behind closed doors, they consider appeals from highly indebted countries whose debt may steam from military conflict dictatorship or governmental problems.

- Debtors are often recommended by the IMF, and only after they have already tried austerity plans and other reforms.

- A Paris Club debt rescheduling or debt cancellation is often viewed as a last resort before default.

Paris Club Analysis: Eligible Debt

Counterparts	Eligibility to the Paris Club
Government: all ministries, Central Banks and other governmental entities	Yes
Public Sector: regions, provinces, municipalities (etc.) and entities and enterprises in which the State or other public entities, alone or together, are directly or indirectly majority shareholders (more than 50 %)	Case by Case
Private Sector	Only in case of non transfer

The Paris Club

- One of the core principles of the club is that no creditor can profit from scheduling of financial sacrifice.

- Since 1956, the Paris Club or ad hoc group of Paris Club creditors have reached over 399 agreements concerning 81 debtor countries. Since 1983, the total amount of debt covered in these agreements has been **$504 billion.**

The London Club

- The **London Club** is an hoc grouping of commercial banks exposed to third world debts. In contrast to the Paris Club there is no formal framework for restructuring commercial banks loans.

- In the absence of a formal framework for rescheduling, the banks with greatest exposure to a country seeking to reschedule its debts will form a committee to cater to the interest of all commercial banks with loans to that country.

- The Committee frequently establishes close links with the IMF in order to ensure an alignment between a debtor's financial requirements and the maintenance of viable economic programmes.

Declaration of Moratorium

- The restructuring process, in relation to sovereign restructuring, commences following an announcement by the debtor state authorities of a specific cut-off date upon which it propose to suspend payment of its obligations. This is accompanied by an announcement of the opening of negotiations to reschedule.

Russia's external debt crisis

- Russia has faced both fiscal and external debt crisis since August 1998.
- The servicing of the debt would have required eighty to ninety percent of the anticipated federal revenue.
- Russia faced a double bind: either it could service the debt and have little revenue for meeting other discretionary spending, or it could default on much of the external debt inherited from Soviet Union and be denied access to the international capital market and internal capital market and international financial institutions.

Debt Relief Provided

- To obtain debt relief, Russia had to first establish itself again with the IMF and agree to a new assistance program before beginning discussions with the Paris and London Clubs on debt restructuring.

  - In July 1999 a Russian/IMF agreement was signed because Russia was in imminent default.

  - In August 1999, the Paris Club provided “framework” agreement on the $42 billion debt. The terms provided for postponement of principal repayment on debt, but continued to require servicing interest obligations.

  - In February 2000, the London Club provided for substantial forgiveness of Russian commercial debt. The London Club agreed to an exchange of the $31.8 billion claims held by the commercial creditors for $21.0 billion in new Eurobonds. This debt reduction translates into 34.5% debt forgiveness. The full debt forgiveness was raised to 52% by providing a lower interest rate and a grace period on principal payment of eight years.

Country and Sovereign Risk Analysis

Sub Sovereign entities

1. **Non Sovereign Public Counterparts**

2. **Governmental related entities**

Non Sovereign public counterparts

Counterparts that both can’t commit the sovereign and have not a private nature as they:

i. don’t have financial autonomy;

ii. are not subject to juridical proceeding.

How to understand if its contractual obligations will impact on the public debt ? The IMF criteria are considered to evaluate the sustainability of the debt.

Which are they, then?

Some **ministries, agencies of the central government, authorities** (i.e. of transportation…)

Governmental related entities

Entities owned by the State (at least 50%) and territorial or other entities that on the basis of the IMF criteria have:

i. financial autonomy;
ii. are subject to juridical proceeding.

Which are they, then?

Companies in the **strategic sectors** (oil, gas, steel…), **municipalities**, **provinces**.

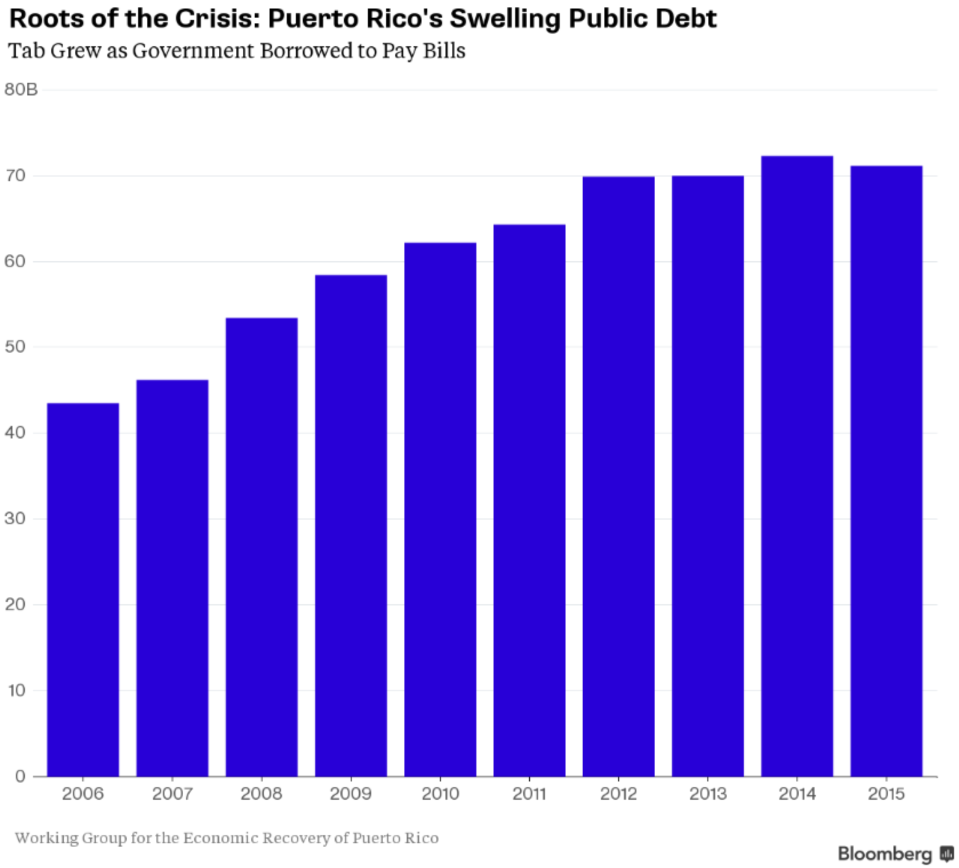
Is this analysis sufficient?

Additional sources of information: local network (embassy, trade commission, chamber of commerce), international financial institutions; etc.

Legal Status

- Local government municipal e.g. city, region
- Government agency
- Autonomous public body
- State owned company
- Special purpose entity
- Non for profit private companies with social mission

Puerto Rico has a problem



- Puerto Rico (Moody's: Caa3) may be unable to pay investors as it looks to restructure $73 billion of debt (out of which roughly $25 billion issued by the public corporations);
- Puerto Rico's bonds have a face value roughly eight times that of Detroit's bonds.

Puerto Rico's legal status is problem

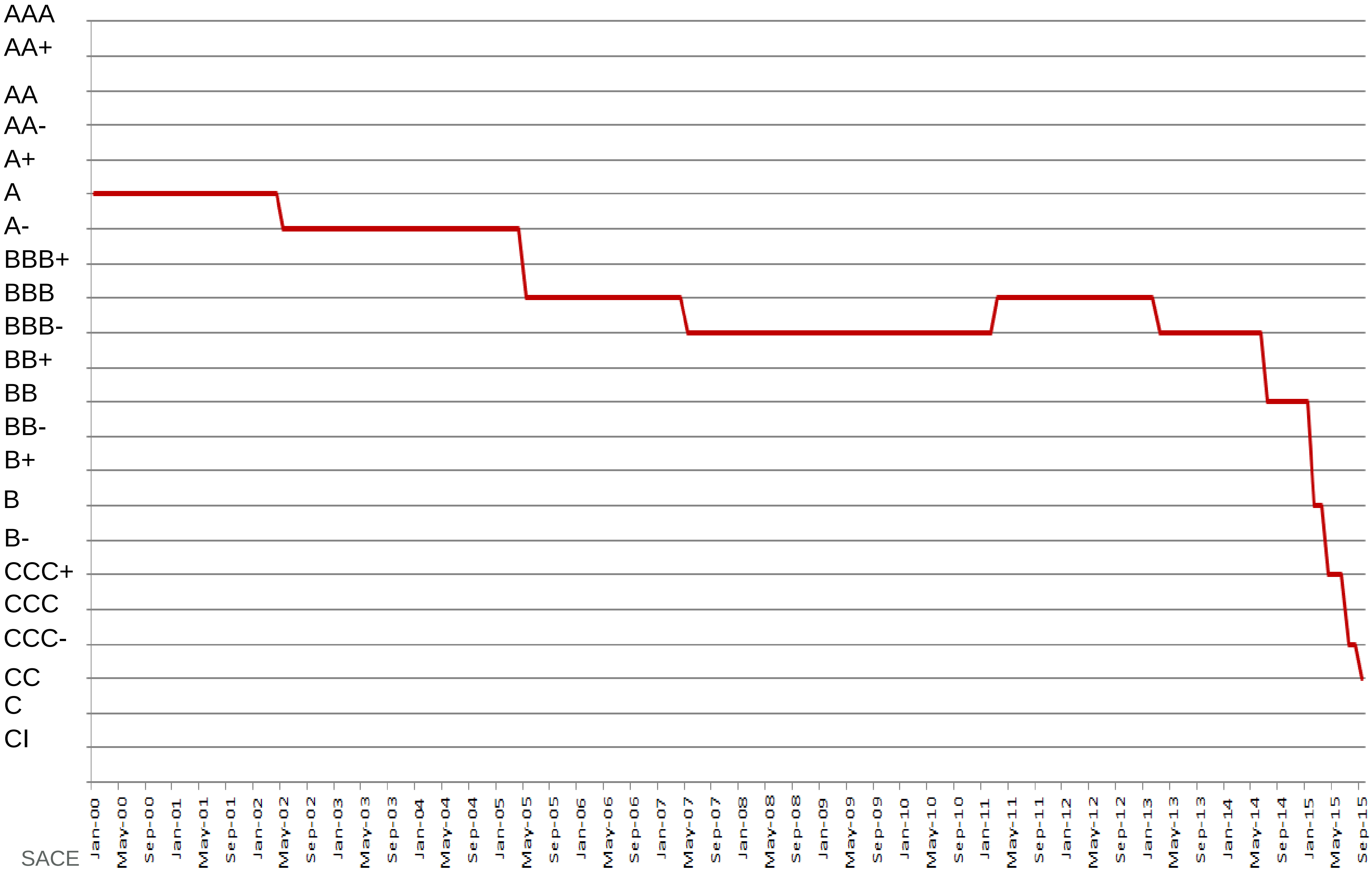
Puerto Rico is part of US Commonwealth, which is type of organized but unincorporated dependent territory.

According to the US State Dept., the term *Commonwealth* "does not describe or provide for any specific political status or relationship. It has, for example, been applied to both states and territories. When used in connection with areas under U.S. sovereignty that are not states, the term broadly describes an area that is self-governing under a constitution of its adoption and whose right of self-government will not be unilaterally withdrawn by Congress".

This status unfortunately implies that:

- a federal bailout of Puerto Rico is not under evaluation;
- As a U.S. commonwealth, the island doesn't qualify for IMF support;
- Puerto Rico does not qualify for any form of bankruptcy under current U.S. bankruptcy laws including Chapter 9 of the U.S. Bankruptcy Code which is for municipalities such as Detroit, Michigan or Chapter 11 which is another option for business entities. because it is under the "Commonwealth" status; it is not a state of the union.

Puerto Rico's rating



SACE

Major dependency criteria to be considered

- **Legal status** indicates the level of closeness with the stakeholder. In case the public ownership is under 30% , it would not be considered as "dependent".
- **Integration** indicates the level of consolidation both budgetary and financial. The tighter is this level the more likely the rating will be equalised to that of the subnational/state.
- **Strategic importance** plays a key role in assessing the probability of a bail-out in the event of financial distress. The more important is the entity's role in fulfilling public services on behalf of the state or the subnational, the greater the likelihood that it will be supported.
- **Control** represents a key evaluation issue and includes factors such as management appointments, the controlling ministry, financial supervision, board control, policy design and implementation, and official audits.
- **Ability**, in term of financial assistance, indicates the capacity of the State to support the sub-sovereign entity in case of financial distress and/or the ease of access of the State/subnational to either bank funding or capital market.

Main issue: Dependency

Level	Criteria	Support
High dependency	• Government ability to support • Government has tight control on entity • Strategically important to the government • Legal status is governmental • Integrated into the government apparatus • Subsides and grants are significant element of revenues	**Highly likely**
Low dependency	• Commercial and profit oriented • May be privatized in the near future • Public sector bail out is prohibited by law • No precedence for rescue for similar Sub-sovereign	**Less certain but possible**

Sub-Sovereign Analysis

Request to assess a SoE/GRE

Official rating or existing internal rating?

NO

YES

Balance Sheet /Financials

NO

YES

Stand-alone Credit Analysis

Update/ adjust rating

Sovereign support play a large role?

NO

YES

Country /Sov. Risk adjustment

Qualitative analysis to estimate sovereign support

Sovereign Risk Rating
De-notching to take into account government support
and/or
qualitative adjustment in case of political issue

How to evaluate a GRE/SoE? A rough approach

			Low	Medium	High	Very high
Government Support to the GRE/SOE	Structural factors	Ownership				
		Management				
	Economic-financial links	Transfer from the government to GRE/SOE				
		Transfer from GRE/SOE to the government				
	Strategic role	Political or economic relevance				
		Public service				
		Investment programs				
	Reputational Risk	Impact on other GRE/SOE or on the sector in case of default				
		IFIs involvement				
			-3 notch down	-2 notch down	-1 notch down	0 notch down

Case study : Dubai World case

- On November 2009, Dubai announced that it would be delaying by “at least” six months the maturity date of $3.5 billion in bonds issued by the city-state’s largest state-owned company, Dubai World, due on December, 14.
- Dubai World was rated as a sovereign risk by rating agencies counting on the implicit support of Dubai central government.
- After the request of delay of the repayment rating agencies cut the ratings on several state companies (such as DP World, Dubai Electricity & Water Authority, Jebel Ali Free Zone, Dubai Holding Commercial Operations Group, Emaar Properties, DIFC Investment) assessing them on “stand-alone basis”.

	Pre-crisis	Post-crisis
DP World	A3	Baa2
Dubai Electricity & Water Authority	A3	Baa2
Jebel Ali Free Zone	Baa1	Ba1
Dubai Holding Commercial Operations Group	Baa1	Ba2
Emaar Properties	Baa1	Ba2
DIFC Investment	A3	Ba1

This is the end!

Thank you for your attention!

Global Solutions

Rome
Piazza Poli 37/42 • Rome

Marco Minoretti - Head of Global Solutions
Tel. +39 06 6736921 • m.minoretti@sace.it