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COUNTERPART AND SOVEREIGN RISK OBSTACLES TO IMPROVED ACCESS TO RISK MANAGEMENT MARKETS: ISSUES INVOLVED, PROBLEMS AND POSSIBLE SOLUTIONS

Report by the UNCTAD secretariat

This report is to a large extent based on inputs provided by Bankers Trust Company, London. Other significant sources include a paper provided by E.D.&F Man (Sugar) Ltd., London, and "Legal and regulatory aspects of financing African coffee exporters and the provision of bank hedging line credit", prepared for an UNCTAD workshop in Nairobi, Kenya, November-December 1993, by Mr. Nicholas Budd of White & Case, Paris. Information was also given by Investment Insurance International, Lloyds Chambers in London; and several of the major international commodity trade houses and major merchant banks involved in commodity trade finance and the provision of commodity price risk management instruments. The presentation of the information in this paper, as well as the interpretation and the conclusions formulated, are entirely the responsibility of the UNCTAD secretariat.

This report is rather technical and presupposes a good knowledge of market-based risk management instruments, their uses and modalities. Readers are referred to document UNCTAD/COM/15, "A survey of commodity risk management instruments", 15 March 1993, for background descriptions.

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INTRODUCTION

1. In the proposals of the Group of Experts on Commodity Exchanges, as endorsed by the Standing Committee on Commodities at its second session (February 1994), the UNCTAD secretariat was urged to undertake in-depth research on problems facing, in particular, entities from developing countries and economies in transition, in gaining access to commodity price risk management markets.[1] The two studies that have been prepared for the Ad Hoc Group of Experts on Risk Management in Commodity Trade treat two complementary sides of these access problems. This document discusses issues related to acceptability of entities from developing countries and economies in transition to intermediaries providing access to international risk management markets, and access problems related to counterparty and sovereign risks.[2]

2. Counterparty risk factors, and in particular sovereign risks, are a major obstacle to the use of risk management instruments by entities from developing countries and economies in transition. Such risk factors come into play every time that an institution such as a trade house or a bank provides credit in some form or another. Thus, it is difficult to separate the discussion of risk management transactions from that of general credit transactions. The discussion below, therefore, has wider implications than only risk management: the same factors that improve access to risk management markets can also improve access to other credit markets, such as those for trade finance.

3. The issue of credit is basic to the use of risk management. Usually, producing or consuming entities cannot afford to immobilize for the purpose of managing risks the convertible currency which they would normally need for upfront payments or for maintenance margins. Therefore, as long as they are required to provide all the funds needed to run a risk management programme, they will for all practical purposes be prevented from using risk management markets. They will be able to make systematic use of risk management markets only when they have access to some form of credit. By its very nature, the management of price risks of physical commodities should allow easier access to credit: a future flow of commodity sales can be discounted to its present net value (which is rather certain once price risks have been taken care of), and then, the credit received in effect amounts to a partial pre-payment for future commodity deliveries; as long as delivery of the commodities takes place, the loan is automatically repaid. But there are fundamental reasons why so little use has been made of this possibility to date. A number of problems intervene, and some difficult conditions need to be met.

4. One of the principal problems is that when a risk management transaction contains a credit component, the provider of the risk management instrument automatically runs a risk of default. The following examples illustrate this for a number of risk management transactions of potential interest to developing commodity entities:

* A government entity storing goods could, through the premiums earned when selling out-of-the-money call options over-the-counter, reduce its costs of storage. If prices increase and the options are exercised, losses will be compensated by an increase in value of the commodities stored on the option transaction. However, the buyer of the options runs the risk that the benefits of higher prices for the commodities will not be used to pay him his dues. If the buyer is not provided with real physical collateral (e.g. title to the stocks), the buyer of such options will effectively be providing credit to the option seller.

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[1] "Analysis of ways of improving the efficiency and use of existing mechanisms for the management of risks arising from commodity price fluctuations - Proposals of the Group of Experts on Commodity Exchanges", TD/B/CN.1/10/Add.1, 27 September 1993.

[2] The companion paper concentrates on the issue of national structures and institution building necessary for allowing access to international risk management markets to those exposed to commodity price risks in agricultural markets.

* A ministry of finance interested in securing its budget, which relies heavily on (export) taxes on a certain commodity, could enter into a swap for this commodity, switching its exposure from floating prices to fixed prices. If prices decline, tax earnings will decrease, but this will be compensated for by payments from the provider of the swap. If prices increase, the ministry will be forced to give up its higher tax earnings to pay the swap provider. Through the swap, the swap provider has put himself into a position to benefit from higher prices. However, as he has no direct access to the extra earnings resulting from higher prices, he relies on the performance of his counterpart for being paid. Thus, he will need either to provide the equivalent of a credit, or to be secured with sufficient collateral.

* A ministry of planning could be interested in locking in a fixed exchange rate for its oil imports in terms of its commodity exports. For example, for the coming three years, the export of one bag of coffee should be sufficient to buy ten barrels of oil, without entering into any barter agreement. This goal can be reached through two separate swaps, or alternatively through a cheaper but also more illiquid direct coffee/oil swap. Again, the risk of the swap provider is that the government defaults when prices move adversely. The swap provider will either have to accept this risk, or obtain sufficient collateral (e.g. control over the earnings from part of the coffee exports).

5. Developing country entities can try to obtain credit lines from brokers for operations on organized exchanges, but the amounts currently available are limited. In general, brokers do not have the capacity to set up and monitor complex credit and security arrangements for guaranteeing large credit lines - their brokerage margins are simply not high enough. They could provide credit lines against money-centre bank letters of credit, but such letters of credit are difficult to obtain for developing country commodity exporters. Nevertheless, developing country companies can often maximize their access to broker credit lines by working with several brokers simultaneously. They can also build risk management clauses into their physical trade contracts, in which case the trade house with which they deal takes care of the cash-flow elements of risk management - at an often not very transparent cost. Although counterpart and sovereign risk issues intervene in this latter type of arrangement, it is not the main focus of this report. Rather, the report concentrates on ways in which access to credit can be enhanced through over-the-counter instruments and on possibilities for improving the supply of letters of credit. Over-the-counter instruments, through their tailor-made character, are especially suited to playing a credit-enhancing role. If they are properly structured (e.g. including the collateralization components mentioned in the previous paragraph), over-the-counter instruments may require little or no upfront cash payments and, in particular, they can serve to insulate clients from the need for urgent cash transfers which can intervene when using exchange-traded futures contracts; thus, they can enable a relatively wide range of entities to manage their price risks.

6. The report examines how counterpart and sovereign risk factors impact on the provision of credit lines and over-the-counter risk management instruments to entities from developing countries (or economies in transition),[3] and then addresses the potential roles that can be played by private sector entities and governments in developing countries or economies in transition, as well as by the international community, in mitigating or avoiding the effects of these risk factors.

Chapter I

COUNTERPART AND SOVEREIGN RISKS

[3] This report discusses the risks that doing business with developing country counterparts causes for banks, trade houses and brokerage companies. It should be noted that developing country entities also face counterpart risks when selecting their developed country counterparts. For example, the Central Banks of Portugal and former Yugoslavia both lost the gold that they had lent to Drexel Burnham Lambert, one of the world's major brokerage houses, during the 1980's when this company went bankrupt.

7. Any deal with a credit component carries with it a risk of default by the counterparty. For example, all imports which have not been paid for upfront carry such a credit component, as do all advance payments or campaign credits for exports, all direct, non-structured loans and many structured loans, and a large number of risk management transactions. In all these cases, the entity providing the credit has a risk of making a loss when its counterparty fails to meet its obligations.[4] Typically, the provider of a credit to a commodity exporter faces several different areas of risk, including:

* In the case of credit to an exporter (or credit secured through exports), will the goods or commodities be produced in the required quality or in the right quantity at the agreed price and on time ?; or if the exporter needs to obtain foreign currency to meet his obligations, will this foreign currency be made available in the amount needed at the right time ?;

* Will the government agency directly or indirectly responsible for policy allow the export even if export licenses have been granted ?;

* Will the government itself still be in power when shipment is to be made, or will a new regime renege on its predecessor's obligations ?

8. Default on risk management deals can result from company-specific factors. However, when developing countries (or economies in transition) are involved, very often, it results from country-specific factors. Trade houses and banks consider it part of their normal business to take on company-specific risks (also called "market risks"). They invest in building up good relations with possible counterparties and in finding out more about how these counterparties function; they will avoid or at least severely restrict taking on the market risks of unknown counterparties, and they will spread out risks over a portfolio of counterparties.[5] On the other hand, to the extent possible they tend to lay off country-specific risks. Company-specific defaults on deals with risk management components can be the result of a bankruptcy, but more often they result from a lack of understanding about the implications of certain price clauses in physical contracts, the working of risk management instruments, or the implications of the use of certain risk management contracts. Many risk management transactions are designed in such a way that, in order to pay for price protection, companies have to give up (part of) their upside potential; when prices then move upward, management is confronted with the need to give up part of the potential extra earnings, but may refuse to do so.

9. Even if a company is perfectly viable, efficient and well-capitalized, and has entered into a risk management transaction fully aware of its implications, it may default on its commitments as a result of certain government decisions. For example, a central bank or other regulatory agency may decide that the commodity prices which are the implicit result of the commodity risk management clause in a contract are too low, and that the deal therefore is illegal. Or governments can block the obtaining of foreign currency for the payment of

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[4] Counterparty risks are additional to other risks that credit providers run, such as liquidity risks (the risk that at a given moment, liquidity on the market on which part of the price risks are laid off is so low that the market becomes useless), or legal risks (the risk that the risk management transaction is declared illegal - this is reported to be the largest single source of losses on swaps).

[5] This explains to a large extent the dichotomy in soft commodity trade houses which has occurred in recent years, with most medium-sized trade houses disappearing. Large trade houses which are able to have offices or agents in many countries, and highly specialized traders which invest in knowing sufficiently about a handful of countries have remained. The "counterparty discovery costs" for medium-sized traders have simply become too large, especially since the export structure of most countries has become rather fragmented.

guarantees or financial obligations.

10. The risk of counterparty defaults is one which banks and trading companies have to take very seriously. Many smaller trading companies have gone out of business because of counterparty default, and such defaults have often led to massive losses for larger trade houses and banks. A not unimportant number of such counterparty defaults by entities from developing countries, and to some extent also from economies in transition, were due to government policies or changes therein. Taking such risks is essential to doing business, but companies have learned that they have to monitor these risks properly and, to the extent possible, build in safeguards against default. Many problems resulting from improper monitoring and evaluation of counterparty risks occurred in the late 1980s and early 1990s, with two results. Firstly, trade houses suffered a decline in their own capital, and an increase in their reliance on banks. Banks traditionally have stricter rules on counterparty evaluation than trade houses. Secondly, many banks have withdrawn from commodity financing, and those that remain have become much stricter in their counterparty risk evaluation procedures, cutting credit lines for many countries, and tightening up their credits and credit policy towards trade companies. In particular, they have moved from an overall evaluation of credit lines for a trade company, to an evaluation of the risks involved in every underlying deal. The consequence of these two parallel developments has been that in recent years, developing country counterparts have increasingly been subjected to the very strict rules and requirements imposed by banks, and the resultant increase in the necessary paperwork for every deal. The capacity of developing country entities to conform to these stricter policies, on the other hand, has often deteriorated, partly because of the decentralization and liberalization of marketing structures.

Chapter II

THE RATIONALES FOR USING OVER-THE-COUNTER RISK MANAGEMENT INSTRUMENTS

11. Traditionally, commodity price risk management was often implicit in marketing deals: such deals stipulated long-term fixed prices, at times for a period of several years. Such fixed price contracts formed an essential part of the trading strategy of a number of the major primary commodity exporters. Given a secure counterparty, they provide guaranteed access to a market at guaranteed prices, for a certain portion of exports or imports. For instance, in the case of sugar, fixed-price long-term contracts accounted for a large part of exports of Australia, Brazil and Fiji, and for a large part of imports of China, Japan and Malaysia. Counterparty risks presented the major risk attached to these long-term fixed price arrangements, and defaults did at times cause very large losses. Several major trading houses as well as a number of smaller, specialized traders collapsed in the late 1980s and early 1990s through a combination of defaults by state-owned entities (or resulting from direct government interventions) and risky trading (often induced by the pressure to recuperate the losses due to these defaults).

12. Nowadays, long-term fixed-price marketing deals are rare, partly as a reaction to past defaults, and partly because of changes in marketing structures for many commodities. Although at times short-term option clauses are included in marketing deals, and various marketing mechanisms can be used to replicate risk management transactions, most entities which manage their price risks now do so directly, not through their physical trade contracts. If an exporter and an importer both enter into a commodity swap, both will receive or pay a fixed price for a period of, if they wish, several years; but the counterparty risk of an importing trader is no longer towards an exporter (and vice versa), but towards a major international bank. With a bank interposing itself between importer and exporter in a commodity swap, both will still have the benefits of fixed prices, but without any real counterparty risk exposure (as the banks involved in general have excellent credit ratings).[6]

13. This does not mean that risk management contracts are now largely traded on a stand-alone basis. Rather, they have shifted from being directly linked to physical trade to being linked to trade finance or investment finance. To a certain degree, there has been a progress from price risk management in physical trade contracts to independent risk management through brokerage companies. But in many cases, and in particular for longer-term risk management instruments, risk management is in one way or another part of a financing deal. In effect, the financing transaction is often the drive behind a deal, and risk management components are later built in to improve the terms and conditions of the financing. Indeed, in the case of developing countries, most use of medium (6-12 months) and longer-term risk management instruments is linked to trade finance or investment transactions.

14. The use of risk management instruments in developing countries is still in its infancy. This is despite the significant exposure to commodity price fluctuations of many groups in developing countries (producers, exporters and governments), despite the fact that those without access to risk management instruments suffer a competitive disadvantage in selling their product compared to those who have such access, and despite the fact that use of risk management instruments can help to reduce trading costs, including "invisible" costs such as costs of credit or insurance costs. For example, many developing countries maintain significant stocks of commodities. They tend to finance this storage entirely themselves, without drawing any significant benefits from this practice; they only benefit from the commodities at the moment that they are sold abroad. However, the commodities concerned are in principle very good collateral for obtaining foreign loans, at lower rates than the loans they now rely on for trade finance, and foreign parties could be made to pay for part of the costs of storage through a variety of modern financial instruments.[7] This is also

radically different from the situation in developed countries, where financing based on the storage of commodities is much more prevalent and confers large benefits to a wide range of companies. Banks are in principle very interested in providing loans against these stocks, as long as they can properly structure

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[6] The banks make a profit in their bid-ask spreads (in this case, the difference between the price quoted to the importer, and the price quoted to the exporter). These spreads used to be rather large in the early years of swaps, e.g. for crude oil up to US$ 1/barrel for a 2 to 3 year swap, but have now declined radically in the more liquid markets (e.g. for crude oil to 15-25 cents/barrel for a 2-3 year swap; this puts the implicit "commission costs", shared by exporters and importers, at 0.3 to 0.5 per cent of the underlying physical trade value of the transaction). As long as those entering into swaps do this on an occasional basis and for strategic reasons (for example for locking in a price that would ensure their operations' profitability) there are no real organizational costs of using these risk management instruments, apart from the training required to ensure that management understands the consequences of the deals entered into. Only when companies start to trade swaps or other over-the-counter instruments actively is there a need for installing new and strong external management control structures.

[7] The only significant exception to this is gold. Several developing country central banks have understood that they can earn interest on this asset, through a choice of techniques including the writing of call options and lending gold to the market. Nevertheless, even this practice is not common, for reasons such as lack of understanding, legal barriers, and political obstacles. Indeed, quite a few of the transactions which have been done so far have been deliberately kept out of the public eye.

the deals to reduce default risk.[8] When providing stock finance, they will often insist on including a risk management facility, for which they then automatically provide the needed credit lines. The failure to use commodities in order to obtain more and/or cheaper finance is due to a number of factors. For one, inventory financing is much more easily available in developed countries than in developing countries and economies in transition, because of the presence of a well-developed banking infrastructure. Also, while developed countries provide the necessary legal infrastructure, in other countries this has to be created on a case-by-case basis.[9] This problem could be addressed by governments through their instituting the relevant standard documentation, and by clarifying the country's legal system.

15. As has been noted in an earlier study,[10] risk management instruments can help developing countries gain access to finance, and/or significantly improve the terms on which financing is secured. This is because through risk management, they can enhance the collateral value of their commodities. Consider pre-export finance. It is often highly attractive for a trade house to provide its developing country counterpart with pre-export finance in order to finance crop purchases, machinery and spare parts for processing facilities, etc. This is often essential to allow the counterpart (exporter) to function properly, and it helps the counterpart to reduce its transaction costs: in the absence of pre-export finance, the exporter will be forced to borrow on the local market, where credit is often scarce, and interest rates are much higher than on the international market.[11] A pre-export credit can be structured in such a way that it is legally speaking an advance payment for future exports of a commodity. Typically, in such a collateralized pre-export purchasing deal the exporter has the right to re-purchase the commodities prior to the export date for an amount sufficient to reimburse the loan, or alternatively, the lender will allow the exporter to sell the goods abroad and repay the loan from the proceeds of the sale.[12] The commodities provide the collateral; but they will only be good collateral if their value is secured, through price risk management. Exporters which have a risk management element in their pre-export financing arrangements will thus be able to borrow more against the same level of exports and borrow for longer periods.

16. Risk management can also improve the terms of project financing by reducing its risks. When risk management is added to a normal financing project, the providers of the finance are often able to expand the amount of finance available and/or improve its terms.

17. In the case of importers, risk management can also help to make financing more viable, because it helps companies to budget their expenses properly. For example, when it manages its price risks, a grain importing agency financed from the government budget knows how much it will have to pay for the cereals it plans to import the coming year, and thus, whether the funds to reimburse a foreign loan will be available or not. This makes it easier for a bank or trade house

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[8] Banks will not make any extra profits when the value of the commodities in stock (or the commodities to be produced) increases, while they are exposed to the risk of a complete loss when the value of these commodities decreases. Thus, they are naturally interested in managing price risks.

[9] See N. Budd, "Financing operations for commodity producers", *International Financial Law Review*, January 1991.

[10] UNCTAD/COM/15, 15 March 1993, chapter III.

[11] In addition, for exporters, it is normally prudent to finance working capital in the same currency as is to be received for sales, to reduce currency risks.

[12] See Nicholas Budd, "A guide to pre-export financing of physical commodities in origin countries", *International Financial Law Review*, January 1991. It should be noted that in practice, it is more common to build this purchasing facility into a "countertrade" facility: the trade house provides priority goods such as fuels, agricultural inputs or machinery, and is later reimbursed through the sale of certain export commodities.

to provide longer-term credits.[13]

Chapter III

EVALUATING THE CREDIT RISKS OF RISK MANAGEMENT TRANSACTIONS

A. Characteristics of credit risk in risk management transactions

18. Risk management transactions often contain a credit component. However, they are different from other types of credit transactions because their marked-to-market value (their change in value compared to the approximately zero-value that they had when the parties involved entered into the transaction) is lower than the nominal value of the transaction;[14] secondly, the "netting" of transactions between various counterparties helps to reduce overall exposures (implicit profits on some deals help to offset losses on others); and thirdly, the risk exposure can be reduced relatively easily through a system of margin payments.

19. The credit risk of a risk management transaction is therefore considerably smaller than the nominal value of the deal. This risk is expressed in a credit equivalent, which can be taken as the maximum expected replacement cost of the contract (with a 90 to 99 per cent certitude, in statistical terms). This makes it possible to compare the "credit content" of a risk management deal with direct loans (which are 100 per cent credit), and thus to compare the two for reasons of decision-making and allocation of resources. The credit equivalent of a risk management deal will be relatively large when one final payment is foreseen at the end of the transaction, and relatively small when regular payments are made.

B. Risk evaluation procedures

20. Large trading houses and banks regularly evaluate the risks of doing business with possible counterparties and their countries of origin. Companies and countries are assigned risk ratings; a company risk rating can be the same as the rating of the country in which it has its base (which is the case for state-owned companies), or it can be lower (in general the case for private companies). The higher the risk, the higher must be the rate of return to induce the trade house or the bank to provide a credit.

21. Country ratings are determined by factors such as political and social risks (including the quality of the political leadership and of the bureaucracy, and the consistency of economic policies); economic and financial risks (including factors such as the diversity of exports and direction of trade, and the past record of the country in terms of external payments and fulfilment of contractual obligations); economic growth momentum; long-term growth potential; and

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[13] Note that currently, many developing countries import grains through preferential arrangements, at prices which have little to do with the world market prices as quoted on the main grain futures markets; thus, the management of grain price risks is currently of little relevance to most public grain importing agencies. This is likely to change soon, when the decisions of the Uruguay Round start coming into effect.

[14] In a perfectly competitive market, the value of a risk management transaction should be close to zero at the moment that the transaction was initiated: that is to say, expected payments (plus transaction costs) should more or less equal expected earnings. When prices (and thus, price expectations) start to move, the financial transaction will start showing a "net value" (or "marked-to-market value") positive for either the bank or its client: expected earnings over the life of the transaction will exceed expected payments, or vice versa. Prices are unlikely to move so much that this net value will exceed the nominal value of the transaction: the experience of banks shows that this marked-to-market value of a very large share of swaps (the most common over-the-counter risk management transaction) falls within plus or minus 15 per cent of the nominal value of the swap. Regulatory requirements in a number of countries, which oblige swap providers to stipulate maximum price bands beyond which no supplementary payments need to be made, also limit the maximum marked-to-market value of swaps.

volatility of GDP and prices (countries dependent on only a few commodities normally rating low in this category). Governments can influence their ratings, sometimes at relatively low costs. For example, they can publicize the improvements they have made in the legal system governing international trade; or they can encourage the reduction in the volatility of export and import prices through risk management. However, there are few indications that governments actually make efforts to directly influence the risk ratings assigned to them by trade houses, banks and insurance companies.

22. A company's risk rating is better than the rating of its country of origin only when the company can prove independent access to foreign exchange outside the country. In all other cases, its rating is at most as good as the country of origin's rating, and generally lower. Deductions result from the level of business risk within the country, the company's track record, the nature of its business, and the assumed quality of its management. The company ratings provided by Moody's and other rating agencies provide one source of such counterparty risk ratings. However, most developing country entities do not have such a formal rating, and banks and trade houses have to make their own estimates.

23. The expected return of a credit transaction is compared to the country and counterparty risk inherent in it.[15] Structuring the transaction (as discussed below) can reduce its overall risks. Whether or not a transaction for the trade house or bank will be acceptable will primarily depend on the expected return, but may also be affected by the overall country credit line.

C. Country credit lines

24. Banks and trade houses prefer not to be overly exposed to one or a limited number of companies, countries or commodities: they tend to build up a portfolio of risks. Country credit lines are used to define the maximum exposure a lender wants to have to any one country. These credit lines are generally determined on a regular basis, e.g. from year to year, on the basis of country and counterparty risk reports which are compiled and collated regularly. These limits are normally not amended within the course of the year. Banks and trade houses may operate one overall credit ceiling for pure credit transactions and for risk management transactions, or they may operate two different credit lines. Even large banks often determine rather limited credit lines: for a typical sub-Saharan African country, the credit ceiling for risk management transactions may be as low as US$ 5 to 10 million.

[15] In the case of swaps with developed country counterparties (that is, swaps with counterparties which have official ratings of Moody's, Standard & Poor's or another rating agency), the link between expected return and counterparty quality is often made formal: when the counterparty is downgraded by the rating agency, either the implicit interest paid on the swap is automatically raised, or the swap is automatically terminated.

25. To determine which part of this country credit line is taken up by a risk management transaction, the highest likely loss of the transaction (at present value) over its period of life is computed. As commodity prices are rather volatile, this value can be quite large. A one-year WTI (West Texas Intermediate) crude oil swap with a notional value of US$ 20 million would carry a credit risk of around US$ 700,000 (compared to only around US$ 25,000 for a US$ interest rate swap of the same notional value).[16] In principle, banks and others can syndicate risk management deals in order to remain within their country credit lines. In practice, however, this is rather rare, as the market for commodity-linked financing transactions is still small. The individual country credit lines of the main banks will thus largely determine the possibilities of a country to enter into a risk management transaction. It should be noted that structured transactions, which provide a performance rather than a country risk, do not add to a country's credit ceiling.[17] Thus, the security arrangements of a deal can be such that senior management decides to ignore the limit imposed by a country credit line (for example, when full collateral in the form of gold is put up).

D. Implications for offer of risk management instruments

26. Two main factors enter into the decision of a bank or trade house to provide a risk management arrangement to a private or governmental entity, whether in a developed or a developing country; firstly, the expected return of the transaction, and secondly, the country credit line. The expected return of a risk management transaction, corrected for the credit risks involved, and taking into account the expected time, human resources and expenses required to structure the transaction,[18] is compared to the normal return on equity of the institution providing for the transaction. Various risk management providers, depending on how they correct for credit risks and on their returns on other transactions, can come to different decisions on certain risk management transactions. Even if the return on a deal may appear attractive, the country credit line may be so low that the transaction is impossible.

27. A third factor also plays a role: capital adequacy requirements to which banks and other financial institutions are exposed. The way these requirements are decided depends on central bank policy and varies from country to country. Usually, banks are required to make provisions against the possibilities of default on credits of one year or longer (and, as noted, many longer-term over-the-counter risk management instruments have an implicit credit component). Such provisions reduce the effective income from a transaction by imposing a higher cost of capital. The size of a provision depends on the risk category to which the deal is assigned, which in turn depends on whether the "borrower" is a private or public entity, which country the borrower is from, and the type of the posted collateral. For example, the Commission Bancaire in France, as well as its Canadian and Swiss counterparts, sets fixed percentages on provisions to be made against loan exposures to every specific country; the Bank of England issues recommendations in this regard. When the lender is from a country with a high sovereign risk, and no special provisions are made to post supplementary

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[16] J.P. Morgan & Co., Inc. (eds), *Commodity linked finance*, Euromoney Books, 1992, chapter 4.2.

[17] Most banks prefer not to structure deals as long as they are able to remain within their country credit lines: this reduces the cost of transactions, and provides them with additional profit opportunities.

[18] Developing country governments and companies thus have an interest in learning about commodity price risk management: risk management providers tend to stay away from a country where they deem too large an educational effort is required. Investment by governments and companies in information systems (well-functioning telephones and faxes, Reuters terminals, and use of personal computers) will also be looked upon favourably by risk management providers.

collateral, the provision the bank has to make can be relatively large.

28. All the above factors have important implications for the provision of over-the-counter risk management instruments to developing countries. In many cases, unsecured deals will be impossible for the bank (as they would exceed country credit ceilings), and even if they are acceptable to the bank, they may be difficult to accept for the client country: financial requirements are too large, or costs are too high. Solutions have been found by structuring a transaction: that is, building into the transaction a number of safeguards in order to provide the lender with, firstly, a clear repayment procedure and secondly, collateral that can be seized when the counterparty defaults. Many banks (which decide to a large extent also on the credit policies of trade houses) distinguish between pure credit risks (e.g. providing the confirmation of a local bank's letter of credit) and performance risks. Loans which depend for repayment entirely upon the performance of a commercial operation do not, for these banks, give rise to credit risk but only to performance risk. Loans depending on performance may be exempted from country credit limitations, and are analysed more in terms of an exporter's ability and motivation to perform its commercial obligations than in terms of country risks.[19] Structuring a risk management transaction (or, for that matter, any credit transaction) helps shift part of the credit risk to performance risk.

29. When structuring a deal, two goals need to be met: first, a well-defined and feasible repayment procedure needs to be formulated; and secondly, sufficient security has to be provided just in case the counterparty defaults on his obligations. In order to structure a financial transaction related to commodity trade in such a way that these goals can be met, several conditions need to be met:

* There needs to be a physical collateral. This implies, in the first place, that the commodity involved has to exist (in stock, in the form of mineral reserves, or in the form of crops in the field), or that its production is planned. Secondly, in order to be useful as a collateral, this commodity has to be exportable (non-exportable assets, such as a processing factory, are of very limited collateral value for international banks and trade houses). To ensure that this is possible, government regulations need to allow these exports, and it is necessary that there is a sales contract, preferably with either a well-known buyer, or alternatively with a small buyer who provides a letter of credit (few small buyers are in a position to do so, as banks are often willing to issue a letter of credit only once the intended clients of these buyers have done so, which is usually just 30-60 days prior to the physical delivery date).[20]

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[19] See N. Budd, "Legal and regulatory aspects of financing African coffee exporters and the provision of bank hedging line credit", paper prepared for an UNCTAD workshop on government policies affecting coffee export marketing, Nairobi, November-December 1993.

[20] This latter factor explains why, in countries where commodities are exported through an auction system, it is difficult, though not impossible, to use these commodities as collateral for risk management transactions. The buyers on the auction, who are exporting the crops they buy, hardly have any need for risk management, or even for pre-financing: they can basically trade on a back-to-back basis. The local buyers (who bring the crops to the auction) are in need of pre-financing and risk management, but cannot sign any forward contracts for exports and thus cannot provide the necessary collateral. In order to allow such local buyers access to the international risk management (and pre-financing) market, a guarantee needs to be given that the proceeds of exports will go towards repayment of the obligations. If the auction system ensures the payment to producers, and the product is exported, the two halves can be put together through a government guarantee. This is done, for example, by the Turkish and Argentine governments for their tobacco auctions.

* The collateral needs to be protected against the risk of disaster (drought, flooding, sabotage) and political risk. Insurance against both types of risk, in United States dollars or another convertible currency and payable to banks or traders outside the exporting country, needs to be available.

* The commercial and bankruptcy laws of a country should be in order: a bank should be allowed to seize, without too much delay, the collateral if the counterparty defaults.

30. It is rather complicated to structure risk management deals in such a way that credit risk is mitigated. This can be exemplified by the amount of documentation that is required - over a hundred pages of contracts, guarantees and other forms are no exception. Countries and companies which are not ready for such documentary requirements are badly placed to access the international risk management market.

Chapter IV

WAYS TO OVERCOME CREDIT RISK PROBLEMS IN COMMODITY PRICE RISK MANAGEMENT TRANSACTIONS

31. For most commodities traded on organized exchanges, a few developing country entities have been using futures and options, but largely on the basis of upfront payments. Credit lines have been extended in only very limited amounts, and mainly for large, state-owned companies with a good track record. Over-the-counter commodity price risk management deals have also been done in developing countries, mainly for crude oil, fuel products, gold, silver and copper, and for a rather diverse group of countries including Algeria, Angola, Argentina, Congo, Ecuador, El Salvador, Ghana, Mexico, Nigeria, Papua New Guinea, Thailand and Trinidad and Tobago. But overall, the use of risk management instruments has been limited, due to a number of factors: lack of understanding on the part of government policy makers; lack of knowledge and organizational problems within the companies/entities which would benefit from risk management; a sometimes inappropriate division between those who would potentially benefit from risk management and those who are paying for it (for example, this is the case when the company involved is not allowed to keep its own foreign exchange, but has to cede it to the central bank); an inappropriate legal framework; and country policies, including policy on foreign exchange controls. However, a further problem has been the inability of the agency providing the deal to structure it in such a way that what is offered is acceptable to the developing country entity, while the security obtained is sufficient to overcome the agency's sovereign risk barriers.

32. High upfront premiums, the posting of a collateral which is large in comparison to the nominal value of the transaction, and the paying of a relatively high rate of implicit interest on the capital provided will in general be sufficient to induce a trade house or a bank to extend a credit, including the credit implicit in a risk management deal. None the less, the terms of such a credit are likely to be costly and thus unacceptable to the developing country entity. However, better terms are possible only when conducive conditions are put into place by the company and the country involved. The major such conditions are discussed below.

A. Track records and company information

33. Institutions providing risk management facilities generally require full information about the company which would be its counterparty, to determine, for

example, whether the company is viable and well-managed. Thus, information on a company's track record is required. Potential counterparties which have defaulted on contractual agreements with overseas parties are unlikely to be considered for a risk management transaction with a credit component. They must also have a good reputation for meeting their financial obligations vis-à-vis suppliers, customers and lenders. The commercial strength, reputation, credit rating and payment record of not only the direct counterparty, but also of any other parties involved in the production, delivery and marketing of the commodity concerned are also analysed. The provider of a risk management instrument also needs to be convinced that the entity is properly managed and has the financial structure to execute its obligations.

34. Providers of risk management facilities also need to determine whether the distribution of costs and benefits of the risk management is such that those bearing the risks have the incentives to manage them (if not, the risk management programme may not be executed). Information in this respect should include details on the levels, timing and computation of taxes by the government and on subsidies and other payments. For instance, if the prices for oil products that a state-owned refinery is allowed to charge are determined on the basis of the average import prices of crude oil (as is the case in many countries), the management of the price risk of oil imports may be of interest to the government, but the refinery itself bears no price risks and thus has no incentive to manage a risk management programme. If a risk management programme for a state-controlled importing agency is secured through exports by another state-controlled agency, then this second agency must be able to benefit from the transaction in one way or another (that is, the government needs to set up an appropriate system for internal financial transfers).

35. Getting to know a counterparty is thus extremely important for providers of risk management. Developing country companies intent on implementing a risk management strategy may do well to invest in building up a good relationship with one or more providers of such instruments. In many cases, it may be easiest to start by buying an option (or an option-related instrument), which entails no default risk for the option provider. As the relationship develops and a positive track record is established, the option provider may become more comfortable with taking on the credit risk of its counterparty.

B. Countertrade

36. Many of the traditional sources of credit (commercial bank credit; trade credits; export agency insurance; forfaiting) have dried up for developing countries. The various forms of countertrade and barter have remained as relatively good carriers of credit to developing countries. Risk management deals can be included fairly easily within such countertrade and barter deals, because among other things escrow accounts, a main vehicle for securitization, are often part of the arrangements for countertrade. Also, sovereign risk insurance for countertrade deals (see section F) is relatively easily available and relatively cheap.

C. Offshore margin accounts

37. Virtually no developing country company is in a position to obtain access to risk management instruments without providing some form of security. One major way in which this security is structured is through the opening of an offshore account - hence, if national regulations make such an offshore account impossible, companies will in most cases be prevented from accessing international risk management markets. Funds need to be maintained in this offshore account as security. Usually, counterparties are asked to deposit an initial margin, and then to maintain a variation margin if either prices or

credit conditions move adversely (that is, their position is marked-to-market). The offshore account is normally interest-bearing. The highest level of collateral is normally required at the beginning, and funds can be gradually released as time goes by. The offshore account can be started with a cash deposit, or with the proceeds of one of the country's main exports (normally, but not necessarily, those of the commodity being hedged);[21] for the time being, it is easier to use fuels and metals for this purpose than to use soft commodities, because banks feel more comfortable with the markets for the former. Thus, for example, the proceeds of one month of exports could be assigned to an offshore account, and then serve as a guarantee for a one-year swap with quarterly payments.

38. Take, for instance, the case where an exporter wants to put a floor on the prices he receives, i.e., wants to protect himself against the risk of price declines. This is equivalent to the purchase of a put option, and does not carry any counterpart risks for the company which sold the option. However, the premium costs of such an option for the exporter can be high, and he can subsidize the put option by selling a series of call options. When he sells call options, the company buying these options will be exposed to counterpart risks, and will normally insist on security. As the risks that the exporter carries on the options are fully covered by his physical exports, if the proceeds of a sufficient part of these exports are credited to an offshore account held or controlled by the company which bought the options, virtually all credit risks are eliminated.

39. In a similar way, countries can organize the price risk management of their imports. For example, a country which heavily depends on exports of cocoa and coffee, but imports fuels, can effectively lock in a maximum amount of cocoa/coffee to be paid for every barrel of fuel. The country would buy call options on fuels and put options on cocoa or coffee, and in order to reduce the costs of the transaction, simultaneously sell call options on cocoa or coffee (giving up part of the potential to profit from export price improvements). To securitize this deal, part of the proceeds of the cocoa/coffee exports would have to be credited to an offshore account. If the organizations importing the oil and those exporting the soft commodities are different ones, the links between them need to be strong in order for such a structure to be acceptable to the company buying the call options. For example, both could be state-owned companies subject to the authority of the government (which may then be required to guarantee the transaction). Independent exporters may object to these deals as they would be exposed to a risk of default by the importer, and would face delays in their payments due to a partial retention of their receipts. Also, the timing and level of compensation paid by the importer to the exporter may create problems.

40. The disappearance of marketing boards for soft commodities in many countries makes this type of securitization arrangements for import prices increasingly difficult. Although importers could still sell put options to reduce the costs of their purchases of call options, the risk management providers will insist on some form of credit guarantees. If it is impossible to have an exporter provide this guarantee, the importer may well be obliged to provide cash collateral upfront.

41. In principle, offshore accounts are easy to set up, but obstacles can occur, especially when the cash collateral is expected to be built up through retention of export proceeds. One of the most frequent obstacles is foreign exchange controls, such as export retention schemes which require that exporters release their proceeds to the central bank within a limited time period. Liquidity problems at the country level may also make it politically difficult to block foreign exchange for such purposes. Legal restrictions, including the negative

[21] For example, one developing country private company provides collateral for an oil import swap by having the payments for its copper exports pass through an escrow account.

pledge covenants which form part of most World Bank and International Monetary Fund loans, may also make it extremely difficult to provide sufficient collateral. Furthermore, when there are many small overseas buyers, more time is needed to obtain their approval and to amend payment instructions in such a way that export proceeds are redirected into the offshore accounts; moreover, such small buyers can cause additional credit risks in themselves.

D. Other possible ways to provide security

42. Trade houses will often try to "bank" the credit risks of their risk management transactions by having a prime bank provide a letter of credit. However, if the client is a developing country company, such letters of credit are in general very hard to obtain, mainly because they would enter into the bank's credit risk evaluation procedure, and fall under its country credit lines. This is even the case if the developing country company provides a letter of credit from its local bank, because banks tend to consider letters of credit by other banks, except when provided by one of the few prime banks, as poor collateral.

43. One relatively popular way of providing security is the pledge of physical inventory. Inventory of the commodity being hedged or any other asset of lasting value can be made into collateral for a risk management transaction. For example, when gold is stored in a Western central bank, a warrant on this gold can turn it into collateral. Other metals are also used for this purpose. When there are reliable local warehouses, managed by a widely respected international custodial agency, local stocks can also serve as collateral. When commodities move into such a warehouse, the ownership title can be automatically transferred to the international buyer, providing him with good collateral. For example, the Sudan at one time received pre-export credits for its cotton, which were collateralized by the stocks in its "field" warehouses (which were supervised by an international custodial company). Such stocks will need to be physically checked, and the legal conditions in the country examined, to determine whether the title to the stock warrants provides sufficient security. Unfortunately, such supervised warehouses are absent in many countries, in particular in Africa, and legal conditions are often ambiguous.[22] Whenever local stocks are used as collateral, sufficient insurance cover needs also to be available - which in many cases may prove difficult.

44. Security can also be provided by local banks, in the form of performance bonds. These are usually available at a low cost for companies with a reasonable balance sheet, and even if they are expressed in local currency, they give some security to the buyer. In any case, many international firms providing risk management facilities are not allowed to lend to private borrowers in a number of countries, and need therefore to go through local banks; even if they are allowed to give direct loans, they may prefer to cooperate with local banks, which can more easily monitor the counterpart's performance.

45. Parent companies based in developed countries can in principle provide all necessary guarantees for a risk management transaction by one of their developing country subsidiaries. For purely physical trade deals, including fixed-price forward deals, this is indeed done. However, it appears that in those cases where a swap has been arranged for an investment project in which a major transnational was a partner (such as a copper swap with a Papua New Guinea company), the foreign parent company has insisted on a stand-alone basis and refused to give any guarantees.

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[22] The creation of a system of supervised warehouses, able to give out warehouse warrants that are considered reliable by the international trade, can be one of the main spin-offs of the creation of a domestic commodity exchange, trading either forward or futures contracts. A bank can also decide to take over a warehouse (putting its own management in place) and issue warehouse receipts to itself. While this was not uncommon in the past, it is no longer often done; it may be a highly interesting option for developing country banks, giving them a comparative advantage over foreign banks.

46. Government guarantees will in many cases improve the risk profile of a transaction, even when state-owned companies are concerned, as it is considered that governments are less likely to default than their companies. Government guarantees are most useful for strategic hedges, with large volumes and long maturities. However, in those countries where IMF and the World Bank are closely involved in macroeconomic policy formulation, these agencies often pressure governments not to guarantee additional offshore transactions.

E. Sovereign risk insurance[23]

47. A very large part of all transactions with a credit component (imports, pre-financed exports as well as most risk management deals) are insured against sovereign risks.[24] Only a few banks are able to structure transactions in such a way that short-term risk management facilities (for less than one year) do not require any third-party insurance. The existence of the insurance cover is normally unknown to the developing country actors, because insurers insist on confidentiality. If the trade house or bank concerned divulges the fact that the deal is insured, the insurance is automatically cancelled (a trade house can lose its insurance coverage even when disclosing the existence of an insurance policy to its financing bank). If insurance is not available, most larger trade houses and banks will either abstain from providing credit to the country, or build a high risk premium into their margins. There are different categories of sovereign risk insurance available, and the availability of insurance coverage, as well as the premiums to be paid, differ from country to country and from category to category. Governments, through their policies, can have a large influence on the premiums to be paid. Adopting proper policies and an appropriate legal framework would reduce the overall costs of insurance for the country, and would allow the shifting of insurance cover from a relatively expensive (and scarce) category to a cheaper one.

48. To simplify somewhat, there are four basic types of sovereign risk

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[23] Forfaiting and factoring, which work in much the same way as sovereign risk insurance, are not discussed here. Forfaiting companies (often part of banks or in some cases owned by insurance companies), often at the instigation of the importer, buy goods from the exporter, as evidenced by promissory notes, and discount them at a fixed rate (that is, they provide pre-export finance). At delivery time, the exporter will deliver the goods to the importer, and the forfaiting operation will be offset. Forfaiting companies assume full credit, political and interest rate risks on the goods (although they can lay off some of the risks in the secondary forfaiting market). The customers pay a somewhat higher margin than with normal commercial lending because the forfaiter assumes all the risks. Factoring is similar but on a more short-term basis. As is the case for forfaiting, factoring companies take over all risks, at a fee several percentage points above base lending rates. In practice, the driving force behind forfaiting and factoring is their credit-enhancing role; according to available information, this type of operation has so far not been used to lay off the counterparty risks of risk management deals.

[24] That is, they are insured against:
- a failure of a governmental exporter to ship the commodity or the failure of a government guarantor to repay an advance;
- a failure of a private exporter to deliver the commodity owing to a change in export regulations or government interference; and/or
- the inability of a foreign company to ship the commodity owing to cancellation of export licenses, or confiscation, expropriation or nationalization of the commodities.

(see N. Budd, *op. cit.*, 1993. It will be very difficult for developing countries and economies in transition to enter into risk management transactions for periods of more than three years: sovereign risk insurance policies are rarely available for periods of more than three years. A solution would be to build into the transaction the possibility of unilateral cancellation of the transaction by the lender after, for example, two years (with the outstanding net value of the transaction being paid in cash).

insurance.[25] The first type is insurance against non-delivery (contract frustration) by a private entity, for example because the government repudiated export licences. The country limits for this type of insurance are rather low, and insurance premiums are relatively high.[26] The second type is insurance against contract frustration by a government agency, or under a government-guaranteed contract. This insurance is cheaper than the first type, and more easily available.[27] The third type of insurance, which is the cheapest and the most widely available, covers the risk of contract failure due to confiscation or nationalization of, among others, the goods provided as loan security. The fourth type of insurance is against the risk of contract frustration on countertrade and barter, in effect a sub-category of the other two categories of contract frustration, which has become relatively easy to insure, at low rates. The need for this type of insurance has increased rapidly in recent years.[28]

49. Sovereign risk insurance is normally available only for periods of up to three years. This creates an important barrier to longer-term risk management transactions. Insurance coverage is provided by both public and private insurance underwriters. Public schemes include the Multilateral Investment Guarantee Agency, part of the World Bank, which currently does not provide sovereign risk insurance on risk management deals; government agencies (in both developed and developing countries); and private insurers. Government agencies include agencies such as Coface (France), Hermes (Germany), and some special schemes set up to facilitate trade with certain countries or groups of countries.[29] They are often prepared to underwrite contracts in the national interest where the risks are unacceptable to commercial insurers. On the other hand, they usually have rather limited lists of countries for which insurance is available. The only government agency providing significant insurance for risk management deals with developing countries appears to be the Overseas Private Investment Corporation (OPIC), in the United States of America. OPIC offers coverage against certain political risks that would prevent a private exporter or importer in a developing country from meeting its obligations under a swap contracted with a United States intermediary involved in a private sector

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[25] Based on information from Lloyds Chambers, London, and the following two papers: Investment Insurance International (III), *Political and financial risks in overseas contracts - the insurance available from the commercial market*, London 1992; III, *Investment insurance coverage*, London 1992".

[26] Just like banks, insurance companies define maximum exposure towards individual countries. For medium-risk countries, the capacity of the main private underwriters can be estimated at about US$ 100 million. For some of the high-risk countries, not more than US$ 10 million is available.

[27] Rates are lower in particular because the risk of the central bank blocking a payment in foreign exchange by a private company is larger than that of the central bank blocking payment by a government company (in recent years, it has happened quite regularly that letters of credit by private companies were blocked, whereas state-controlled companies were still allowed access to foreign currency).

[28] This is particularly useful for countries such as Angola, Iran, Peru and Nigeria, where it is difficult to find insurance coverage, and for countries such as Indonesia and Malaysia which have onerous countertrade requirements. In many cases, insurance is taken on to cover the situation where goods have been delivered and accepted by the buyer but the exchange goods, e.g. oil, have not been delivered. This may be due to a law preventing the export, or even a law preventing the import of the goods from the seller’s country.

[29] For example, in late 1993, the Russian Federation was planning to set up a sovereign risk insurance facility, based in London and guaranteed through a US$ 100 million deposit of gold and gemstones in a Swiss bank; practical problems have so far prevented the implementation of this scheme. The European Union and various countries have set up sovereign risk insurance schemes specifically for trade with, and investment in, the CIS republics and the countries of Eastern Europe. It appears that these schemes do not yet cover pure risk management transactions, but are being used for investment and trade transactions with risk management components.

project in an OPIC-eligible country.[30] The private sovereign risk insurance market is fairly recent, having started only in the mid-1970s. Private insurers accept virtually every country, including those not covered by national agencies.

50. The limited availability of sovereign risk insurance has constrained the offer of longer-term risk management instruments to developing countries, and the high costs of such insurance has made certain possible transactions unattractive. Through their policies, countries can move from one sovereign risk insurance category to another, expand access to insurance by their credit and risk management providers, and bring down the insurance premiums to be paid. Sovereign risk insurance premiums can differ widely. For example, in early 1992, the private market premiums for covering contract frustration risks with Angola were 6 to 8 per cent (on an annual basis), while the premiums on confiscation were only approximately 1.5 per cent. For Argentina, these rates were respectively 2-5 per cent and 0.75-1 per cent; for Ghana 3 per cent and 1 per cent; and for Kenya 3-6 per cent and 1 per cent. In all these cases, confiscation coverage was widely available, while contract frustration coverage was limited, for instance to contracts guaranteed by the central bank.

F. Policy conclusions

51. When the political will exists, governments can relatively easily create the conditions that would allow a reduction of overall insurance rates, and a shift in sovereign risk insurance requirements from the category of contract frustration to that of confiscation, thus reducing their countries' costs of international trade by probably over one percentage point. The following steps would help to create such conditions:[31]

* Local laws relating to exports and export financing have to be made clear. A lack of clear rules or frequent changes in rules can make insurance coverage unavailable, or available only at high premiums. Also, laws need to be such that they do not prevent normal commercial practice.

* Local laws relating to title and security have to be made clear. This is essential to ensure that the collateral obtained is indeed "good" collateral.

* Foreign companies need to be allowed to take title to commodities, and to hold export licences, even if only a portion of the eventual purchase price has been paid. If foreign companies receive such title and export licences, their risk becomes one of confiscation of the goods, which can be insured quite cheaply.

* The regulations regarding export licensing need to be made clear, and be adapted to allow for greater security for foreign lenders: foreign companies have to be in a position to receive export licences at the moment that the transaction (provision of pre-finance or a risk management facility) is entered into.

* In the case of a privatization of export structures, the government should extend its guarantees to the newly privatized companies, and make clear its policy of doing so. In this way, foreign companies no longer run the risk that all insurance coverage is lost when a counterpart is privatized.

Any steps taken by a government in these directions would benefit from being

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[30] This insurance covers the main types of political risks but is of limited use for the time being, because transactions with public sector companies cannot be insured. With the liberalization of commodity exports and imports in developing countries, its use to United States risk management intermediaries may increase.

[31] Based on Budd, *op.cit.*, 1993.

publicized widely. Governments can also make a conscious effort to familiarize the major political risk insurance underwriters with their new export policies, in order to ensure that the changing policy environment is indeed reflected in more easily available and cheaper insurance coverage.

Chapter V

KEY OBSTACLES TO A GREATER OFFER OF RISK MANAGEMENT INSTRUMENTS TO DEVELOPING COUNTRY ENTITIES, AND POSSIBLE ROLES OF THE INTERNATIONAL COMMUNITY

A. Country-specific barriers influencing counterparty risk evaluation

1. Organizational and economic policy barriers

52. Among the main barriers at country level for the completion of risk management programmes one can mention an overly bureaucratic functioning of organizations, and a lack of incentives for institutions and individuals to take decisions. Such conditions can stifle any progress towards a viable risk management policy. Economic policy conditions may also make it impossible for an entity to enter into risk management transactions. The main barrier in this respect is the existence of inappropriate foreign exchange regulations; taxation policies and a policy of minimum export prices may also be hindrances.

53. Foreign exchange controls (as well as shortages) may make a risk management transaction legally impossible (see below), but even when these controls are such that a risk management transaction is feasible, they may restrict a counterparty's ability to meet foreign exchange obligations, in particular obligations for large amounts or which need to be met in a short period of time. When the offer of foreign exchange is controlled by the central bank, the risk of providing the risk management facility is deemed higher than when foreign exchange is sold freely on the open market. Countries do not need to fully liberalize their capital flows to enable the use of risk management instruments; for example, a policy of specific credit lines, in foreign currency, approved by the central bank for specific producers, exporters and others which are deemed to have a legitimate need to manage their price risks, may already give sufficient flexibility. More broadly, central bank regulations and other government policies should specifically authorize hedging operations; such hedging operations are a normal part of any pre-financing arrangements, and will be entered into anyway, even if illegal. However, if illegal, this creates additional risks to the lender, and thus will result in a higher risk premium for which, ultimately, the exporter and its country pays.

54. Value-added taxes can be a major hindrance to using local stocks as collateral. As described before, a foreign lender will often require the transfer of a title of ownership in order to accept commodities in local warehouses as collateral. If he then is asked to advance value-added taxes, this adds considerably to the costs of the transaction (in terms of liquidity costs and paperwork costs). This problem can be overcome if taxation authorities recognize this type of transaction as an off-balance sheet transaction and treat the commodities involved as bonded warehouse stocks.

55. Similarly, policies determining minimum export prices may make it more expensive for developing country producers or exporters to obtain access to finance or risk management. Access will not be completely prevented, but in order to meet their commercial obligations, producers/exporters may have to resort to illegal means, such as shipping additional, undeclared commodities. While de facto this may in many cases be accepted by customs officials, it does contravene export regulations; in the first place this creates risks, and in the second place it may lead to the automatic cancellation of a sovereign risk

insurance policy.

2. Legal barriers

56. International banks and trade houses will be hesitant to enter into a risk management transaction if they are not sure about its legality and about its enforceability given local legal conditions. Many legal conditions make it exceedingly difficult to structure properly a risk management transaction; in other cases, it may be hard to obtain sufficient certitude about legal conditions. These are among the principal obstacles to the provision of risk management instruments to companies in developing countries and economies in transition. Legal counsel, often both local and offshore, is in general required to ensure that a transaction is possible within the country's and the counterpart's legal conditions. It is often difficult to obtain quick and reliable information on the legal validity and enforceability of the proposed transaction. Legal opinion is also expensive; and given that a typical gross margin on an export pre-financing transaction of US$ 10 million (the maximum most banks are willing to pre-finance in particular for soft commodities in any single country) is some 2 per cent, or US$ 200,000, it is clear that high legal fees can quickly make a transaction unattractive. Countries would benefit much from clarifying their rules and regulations. Some legal barriers affecting the availability and cost of sovereign risk insurance have been discussed in chapter IV.E. Other problems include the nature of local approvals needed to execute the transaction; the impact of foreign exchange regulations on the proposed structure; the enforceability of the risk management transaction, of the underlying trade contracts and of the security arrangements; possible negative pledge covenants; and, particularly in the case of transactions involving gold, the possibility of claims of sovereign immunity.

57. Those providing risk management facilities usually prefer that the export contracts for the commodities being hedged be assigned to them. Among other things, and as discussed in chapter IV.E., this would be one of the conditions for allowing them to take out insurance cover against the risk of confiscation, rather than the more expensive and scarcer insurance against contract repudiation. The regulations governing export licences are thus of particular importance. Many countries do not permit the issuance of export licences until the physical commodity exists, the export price is fixed, and a letter of credit is issued. Also, many countries allow export licences to be issued only in the name of licensed exporters, without a right to transfer them to foreign entities; and they issue only export licences which expire when not used by a certain date.[32] Each of these conditions has a negative impact on the usefulness of the commodity as collateral, and thus on the availability and cost of credit (including through a risk management transaction). Changing these rules can greatly facilitate access to pre-export finance and risk management facilities.

B. The influence of the policies of international organizations: negative pledge covenants

58. One of the principal obstacles to governments applying for commodity-linked finance may well be the loan policies of international financial institutions, in particular the World Bank, International Monetary Fund (IMF), European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ASDB). These organizations include in their loan conditions a negative pledge clause

[32] See Budd, *op.cit.*, 1993, for a further discussion of this issue, and for suggestions as to how export licence regulations can be amended to improve access to credit.

or covenant. Such a clause broadly prohibits government agencies or "instrumentalities" (such as state enterprises) from pledging or otherwise encumbering their principal export commodities as security for loans or other financial accommodations, including risk management transactions. These commodities include the gold reserves of the central bank, crops (including future crops), mineral and fuel reserves. Thus, securitization mechanisms such as escrow accounts fuelled by the proceeds of the export of commodities by a state entity are forbidden. Clearly, even if unintended, one effect of such clauses is to make it more difficult for sovereign borrowers to offset commodity price risk by engaging in commodity-indexed finance and risk management facilities, which normally require the borrower to pledge, or pass title to the physical commodities to be exported.

59. The World Bank, IMF, EBRD and AsDB normally provide unsecured loans, and do not wish to see their access to future financial flows from their borrowers diluted by the pledging of commodities to third parties. Including such negative pledge clauses in loan agreements helps these organizations to maintain their high credit ratings, which allows borrowing on the international market at the lowest possible rates. It is also claimed that negative pledges protect governments from the temptation to mortgage resources long into the future to meet current needs.

60. Government entities have at times ignored the negative pledge clauses in their loan agreements and committed part of their commodities as collateral in risk management transactions they undertake with private banks, against which the lending agencies in practice have only very limited possibilities of recourse. However, it should be recognized that this procedure is not optimal. The legality of this type of collateralization is not clear, and thus good sovereign risk insurance becomes virtually impossible. This adds to the costs and makes transactions difficult to structure.

61. The World Bank and others recognize that negative pledge covenants can cause serious problems for their client countries, in particular that private lenders will be highly unlikely to provide finance on an unsecured basis. The IMF has for some time now allowed the use of escrow accounts by countries with scarce foreign currency reserves. The World Bank decided only in 1990 to introduce the possibility of waiving the covenants on a case-by-case basis. In March 1993, this policy was strengthened by the decision to allow, in principle, generic waivers for certain categories of transactions and for certain countries.

62. Nevertheless, these new rules were not very satisfactory, and compared unfavourably with, for example, the conditions accepted by the EBRD in late 1993. The World Bank found that no countries met the tough conditions set out for generic waivers. It came under strong pressure to change its policies when it became clear that billions of dollars in oil investments were held up because of World Bank negative pledge conditions. In November 1993, the Bank moved to conditions close to those of the EBRD.

63. Current World Bank conditions for waivers still appear unnecessarily strict. Among other things, conditions are such that only countries where the government controls over three quarters of the productive assets can apply. Also governments need to have accepted a programme of structural change. Waivers can only be used for project finance and only the commodities produced in the project can be pledged as collateral. The minimum term of the finance is five years and

the project must generate sufficient additional foreign exchange. This implies that countries where the private sector is quite large but does not have the sophistication and counterpart reputation to enter into structured finance deals are left in the cold. Securitizing a budget-oriented operation through central bank gold guarantees is not allowed. Operations where commodities different from those produced in the project are pledged, for instance coffee exports to securitize an oil import swap, are impossible. Thus, virtually all import-related collateralized risk management operations would be illegal. The waivers that have been granted, for instance for Nigeria, the Russian Federation and

Uzbekistan, have been for "enclave"-type projects (in particular in the oil sector), which generate clearly identifiable extra export earnings.

64. It is not evident that the World Bank and other international agencies operating similar negative pledge covenants have a legitimate right to impose such strict conditions. The attested purpose of the covenant is to ensure the Bank's access to the expected future income flows of a country. Logically, any project or activity that can only be realized if security is pledged, and which is expected to generate supplementary foreign exchange beyond that needed to repay the credits related to the project or activity, can be expected to increase the capacity of the country to serve all its loans, including World Bank loans. There would thus appear to be no legitimate economic reason to limit country eligibility or time-frame. Limits on the commodities to be pledged are understandable: if the project or activity fails to reach its expected outcome, the total resources freely available to reimburse Bank loans would be reduced. Nevertheless, if this condition were adhered to strictly, governments would be prevented from fully exploiting the possibilities open to them. Instead of the current rigid approach, a case-by-case approach by the Bank (and other lending agencies), comparing expected benefits for the country and disadvantages for the Bank, would appear warranted. As discussed in earlier chapters, the general benefits of being able to provide good collateral for credit transactions, including those implicit in risk management transactions, are substantial, and the World Bank's negative pledge policy would appear to be a major hindrance to countries' capacity to improve their management of trade flows.

C. Possibilities for and problems with an international insurance scheme for sovereign risks

65. Some international agencies put themselves between a developing country user and the provider of the risk management instrument. For example, the International Finance Corporation (IFC) has done so for Ghana's Ashanti gold mine, and, in relation to financial risk management, for several other developing country entities.[33] The EBRD provides the same possibility for currency and interest rate swaps linked to specific projects.[34] Such intermediation plays a direct credit-enhancing role: for the purposes of the bank or trade house providing the risk management instrument, the counterparty is not a low-rated entity but the IFC or EBRD, both of which have very high credit ratings. The entity in the developing country or in the economy in transition pays for this intermediation through the margin which the intermediating agencies add on. This type of arrangement can be seen as a form of insurance. However, the activities of the IFC are rather limited so far, and the EBRD covers only financial risk management transactions; OPIC (see section IV.E) also has a limited role to play in this area.

66. The activities of agencies such as the IFC in taking on the counterparty risks of developing country entities doubtless provide the access to risk management for entities which otherwise would have been locked out of the risk management market, enhancing in the process their overall access to investment credit. This therefore raises the issue of whether there is a need to introduce a more global facility, such as a world-wide sovereign risk insurance fund. There have been informal discussions, for instance, on whether such a fund could function within the First Account of the Common Fund for Commodities, or as an extension of the activities of the Multilateral Investment Guarantee Agency of the World Bank. There is little doubt that if operational difficulties could

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[33] See Jack D. Glen, *How firms in developing countries manage risk*, World Bank, International Finance Corporation discussion paper No. 17, 1993.

[34] EBRD, Treasury, *Intermediation of interest rate and currency swaps for Eastern and Central European Borrowers*, December 1991.

be overcome, such an insurance fund would indeed have a positive effect on banks' and probably trade houses' willingness to provide long-term risk management instruments, provided that the coverage mechanism is simple, that the procedures for reimbursement of claims are not cumbersome, and that the insurance premiums are not prohibitive. If such a facility existed, banks and trade houses would lay off not only the worst country risks, but also part of the country risks for larger transactions where the risks of a transaction make it exceed a country's credit line.

67. The modalities of such an insurance fund would likely depend on the commodities and the countries involved. In some cases the fund would need to cover only the first tier of risks, while in other cases it might need to cover risks above a certain threshold. It could act as a re-insurance facility for the private market, or additionally, take on a more direct role along the lines of the IFC's style of intervention. An insurance fund could underwrite only certain components of risk management transactions, or it could underwrite the whole transaction. The likelihood of the latter being feasible is rather small, given the amounts of capital required and the perceived country risks of all but a few developing countries. More focused forms of insurance, however, would appear feasible. One possibility would be for such a fund to guarantee the letters of credit of selected developing country banks, so that these have the financial status of prime bank letters of credit (which, in turn, are good collateral for most risk management transactions). Another possibility would be to insure against the risk of non-delivery of physical commodities which have been the collateral for risk management facilities. In any case, the insurance fund would need sufficient leverage over its beneficiary countries in case they default on their obligations. This would probably be possible only if its activities were linked in one way or another with those of the main international lending agencies. These issues clearly require considerable additional research.

68. One essential question is whether such a sovereign risk insurance fund could be made actuarily-sound: could it be self-financing ? If it were a profitable venture, it is legitimate to wonder why the private sector has not yet developed such a large-scale fund. Indeed, it is deemed unlikely by most specialists that such a multinational insurance fund could ever be self-financing, unless the premiums charged are so high that they would make insurance unaffordable for a large number of poorer developing countries and so defeat its purpose.

69. This would suggest that, if it is felt that the absence of such a global sovereign risk insurance fund is indeed a very serious obstacle to developing country entities that wish to manage their risks,[35] then it would be necessary to accept that this insurance fund be conceived as similar to other macroeconomic development support or investment support facilities; that is, premiums would have to be partly subsidized by the international community. A rationale for this can be found in the potentially high external benefits of individual risk management transactions. As they would help stabilize not only the earnings of the company involved, but also the earnings of the country, and in all likelihood also the income of the government, they would help reduce the volatility of GDP and exports, which in turn would, *inter alia*, encourage credit providers to raise the country's credit standing.

CONCLUSION

70. This report has shown that private sector entities and governments in developing countries or economies in transition could take steps to mitigate the impact of counterparty and sovereign risk factors on the provision of and access to commodity price risk management instruments. Private entities as well as state entities interested in using such instruments could, in particular, make efforts to improve their standing as a counterparty through, for example,

[35] As discussed before, there are several other ways through which the access of such entities to risk management markets can be improved.

internal training and building up good working relationships with foreign companies, and to enhance their possibilities to provide collateral through, *inter alia*, keeping offshore accounts. Governments could play a major role by providing the proper regulatory framework, as discussed in section IV.E. This framework should make it possible for a country's various economic entities to pledge physical commodities within the country as collateral for risk management transactions. An enabling legal framework concerning ownership, bankruptcy laws etc. is thus needed, as well as enabling policies on, among other things, export licensing, minimum export prices, taxation of commodity transactions, and the use of foreign currency for hedging purposes.

71. The international community could support private entities and governments in the above-mentioned efforts, through appropriate research, training technical advice, etc. It could also take action to reduce barriers for developing countries and economies in transition to the use of risk management instruments, and to provide additional facilities enabling entities from such countries to access risk management markets. One important action would be the modification of the current negative pledge policies of multilateral lending agencies. The latter could also consider playing a larger role in intermediating risk management transactions, for instance when they are providing project or budget finance. Finally, further consideration could be given to the formation of an international sovereign risk insurance fund, focused on insuring specific aspects of risk management deals.