

(ExIm-) Banks working with the PRI Market

- How does KfW IPEX Bank work with the PRI Market to mitigate risk and expand its business
- Recent Experiences

Seminar for Asian Regional Exims
Bangkok, October 18th 2006

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Agenda

- What drives usage of risk mitigants ?
- Requirements for management of risk mitigants
- Recent solutions

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Why do banks need to insure political risks?



- Banks want to serve their customers in many markets, not only in developed countries
- Commercial risks can be rated and secured, e.g. with underlying assets and thus priced accordingly; translating political risk into adequate margins remains challenging
- Despite substantial improvement in country ratings after crises in SE Asia, Russia, Argentina etc., many emerging markets and developing countries remain susceptible to external and internal shocks
- Unstable conditions concerning e.g.:
 - Government/general politics/legal framework
 - Budgets
 - Currencies
 - Financial markets
- Scarcity of two commodities are core drivers to seek protection:
 - Country Limits
 - (Economic) Capital

3

Driving forces in current risk management



Expected Loss (EL) = PD * EAD * LGD, to be covered by margin and fees

State-of-the-art rating tools for:

- Corporates
- Projects (Cash flow based)
- Countries
- Banks

→ Provide good estimate of PD

Collateral:

- Risk mitigants (e.g. insurance)
- Mortgages
- Pledges
- Cash reserves

→ Reduce Net Exposure

Unexpected Loss (UL) is to be backed by Economic Capital (ECAP)

4

Basel II = Finetuning of Capital Requirements

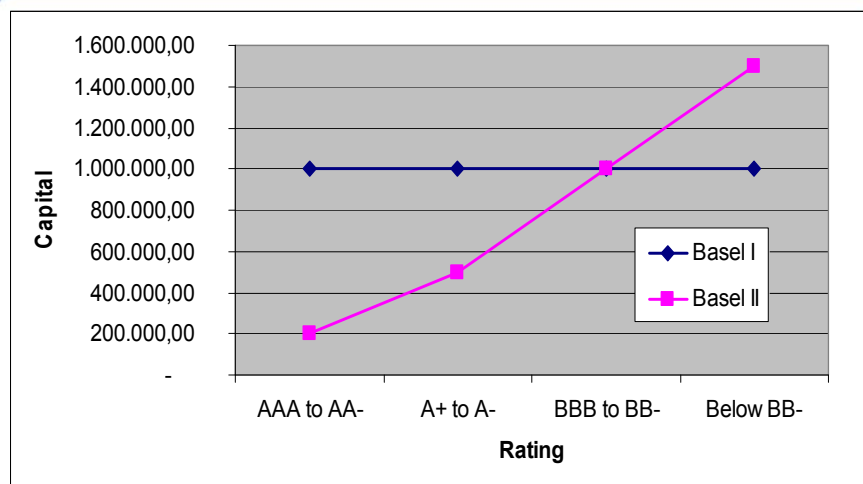


- “International Convergence of Capital Measures and Capital Standards”, drafted by Basel Committee on Banking Supervision, offshoot of the BIS
- A gentlemen’s agreement among leading regulators, implementation relies on national law
- Basel I in 1998 defined crude framework, i.e. zero risk weighting for OECD-risk, 20% when lending to OECD banks (\$500m loans with \$8m capital) and 100% for loans to corporates (\$100m loans with \$8m capital)
- Basel II will finetune risk baskets (standardised approach) plus give banks option to use their own internal historic data to calculate riskiness of its loans (= internal ratings-based approach, IRBA) = greater convergence between regulatory and economic capital
- For this calculation, bank must be able to estimate the probability of default within one year for each borrower, the bank’s potential exposure at such default and the potential loss given a default

**Basel II more than 200 pages longer than Basel I –
10 x more regulation by volume!**

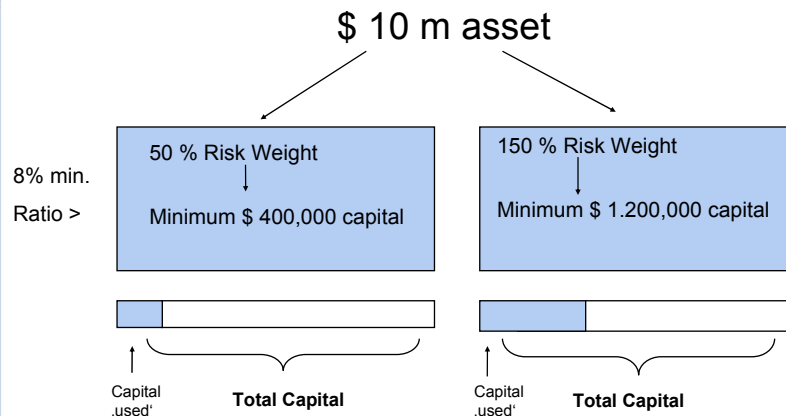
5

Corporate Risk Capital Consumption \$ 12.5 Mio Loan



6

Effect of Risk Weighted Assets



7

What drives using of risk mitigants ?

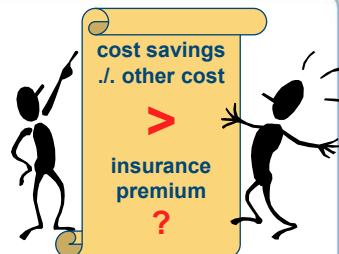


- A good deal in a challenging host country environment is the start
- How much country limit / economical capital is freed by using risk mitigation tool ?
- Determined by
 - ⇒ Credit-Rating of insurer
 - ⇒ Nature of Cover
 - ⇒ Internal Loan History
- LGD-determination for selective events such as LGTE (loss given transfer event) worthwhile modelling, many others very hard to measure in a validated model; establishing of LGDs for events such as expropriation and political violence yet yielding very crude parameters
- Gut feeling of risk manager may drive choosing selective cover
- To finetune approach: Gain experience, warehouse and model data
- Splitting of risk mitigants in guarantees (on demand) vs. insurance with higher recovery cost and longer waiting periods standard

8

Some remarks about cost benefit

- Use of risk mitigant reduces LGD
 - Lower LGD reduces net exposure
 - Lower net exposure reduces ECAP required
 - Lower ECAP reduces capital cost
 - Cost savings
- Other expenses (e.g. enforcement cost, waiting period) can partially offset savings



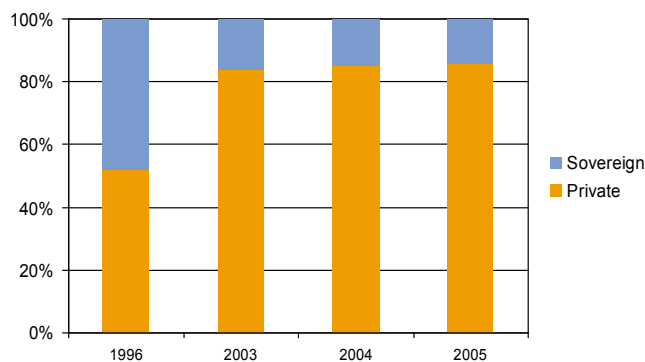
Market factors:

- High liquidity, over-capitalisation and new market players drive credit margins to the bottom
 - Lower margins must suffice to pay insurance premia if premia cannot be passed through
 - Internal country ratings have major impact on competitiveness

9

Borrower status (private/sovereign) affects relevance of credit enhancement tools

Share of private and sovereign borrowers in KfW portfolio



10

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11

A Measured Approach and a Regulatory Perspective



- ⇒ Rating and pricing tools create "closed loop controls", i.e. all loan data are permanently integrated into portfolio model
- High Quality requirements for data management, permanent validation of risk methodology incl. reliability of parameters such as LDG, EAD and PD estimates for specific rating categories
- Basel II: wider range of risk mitigants applicable incl. derivatives (CDS)
- PRI-Policies can be eligible and suitable security
- Value of cover increases if comprehensive and with level of insured indemnity
- Made up in writing, clearly and explicitly documented
- Legally binding and enforceable:
 - ⇒ "The bank may in a timely manner pursue the guarantor for monies outstanding under the documentation governing the transaction."
 - ⇒ Covers all types of payments the underlying obligor is expected to make under the documentation

12

Basel II and non-payment insurance



Non-payment insurance policies are an acceptable „guarantee“ under Basel II, subject to them meeting the operational requirements, i.e. conditions are in direct control of policyholder.

- FAQ #6, BIS website, Oct. 2002

Crucial issues for us:

- ⇒ Clearly define Claims Payment Date, Claims Timetable, Shorter WPs, remove & reword Exclusions

Overarching issue: additional operational risk of using more complex CRM instruments

„....it is imperative that banks employ robust procedures and processes to control (residual) risks“
June 2004 Framework, Para 115

13

KfW IPEX Banks' requirements: the internal ECAP perspective



- Requirements for risk mitigants (personal security) to provide capital relief in an IRB-A proof system (excerpt from internal KfW IPEX Bank Risk Handbook):
 - Type of risk mitigant has been approved as eligible by the bank
 - Up-to-date rating of mitigant provider/guarantor/insurer
 - Robust procedures for timely realisation
 - Reasonable cost-benefit ratio
 - Very purpose of risk mitigant is to be credit security
 - Irrevocable
- In IRB-A environment there should be significant convergence between regulatory and ECAP perspective on risk mitigants

14

Credit enhancement tools in private borrower transactions: ECAs & PRI/IFI



- ECA cover provides seamless protection against defaults: comprehensive cover is provided
- Real risk **TRANSFER**
- LGD effect for banks relatively easy to determine:
Net exposure = Uninsured portion
- No cover of devaluation risks
- PRI and IFI provide protection against selected risks
- Risk **MITIGANTS**, effectiveness to be integrated into portfolio models
- Determining LGD reduction is more challenging:
Risk management tools would need to distinguish between "LG Transfer Event", "LG Breach of Contract", "LG Expropriation", "LG War"
- For sovereign borrower transactions, PRI and IFI provide seamless protection

15

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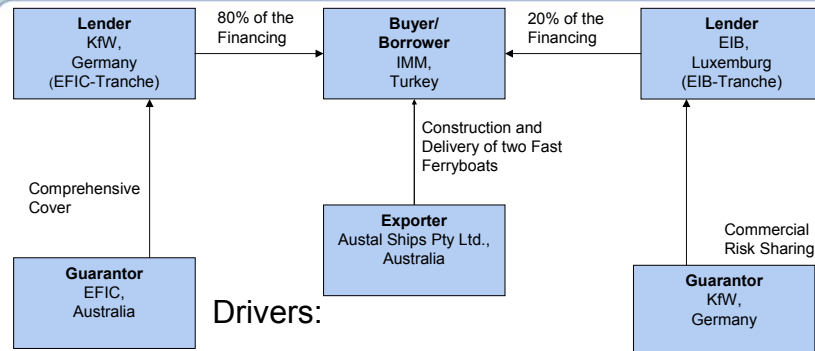


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16

Turkey Long-Term Financing for Sub-Sovereign



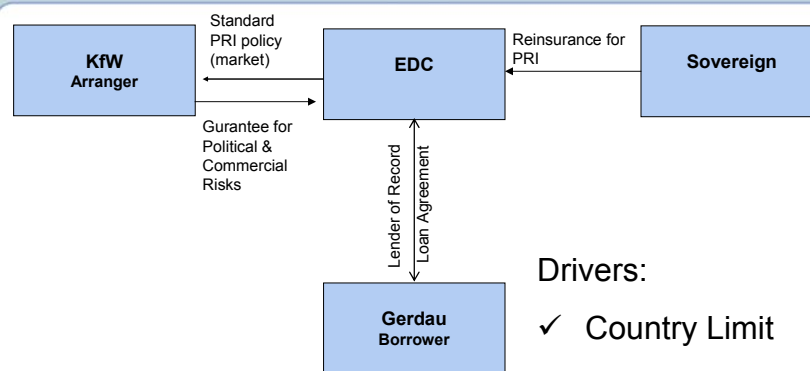
Drivers:

- ✓ Competitive, non-ECA-eligible Tranche
- ✓ Country Limit
- ✓ RAROC

17

Brazilian Steel Mill with EDC

→ Financing of local cost
70% of total project

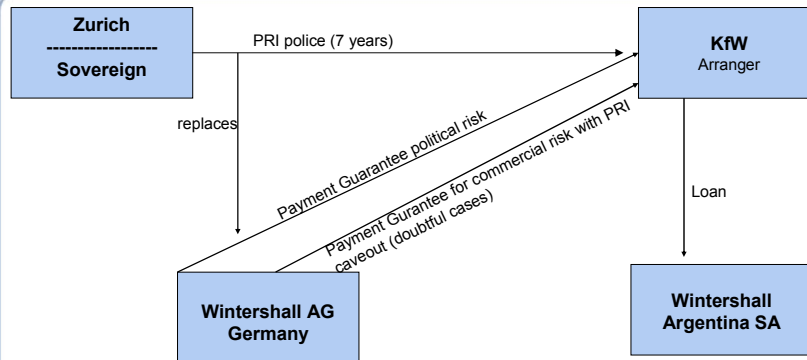


Drivers:

- ✓ Country Limit
- ✓ IWT
- ✓ RAROC

18

Argentina Wintershall → Exploration of Gasfields

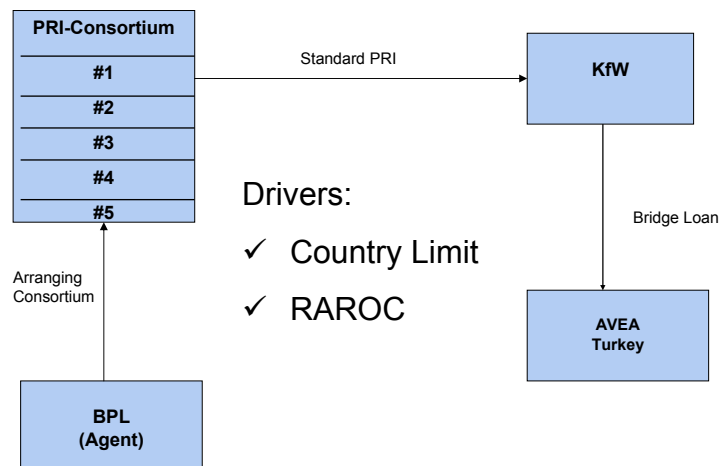


Driver:

- ✓ Clarification of net exposure

19

Turkey AVEA → Bridge Loan



Drivers:

- ✓ Country Limit
- ✓ RAROC

20

Conclusions:

- (1) Establish Methodology
- (2) Key Asset is Diversity of Tools



- Methodologically-sound ECAP-based treatment of risk
- Approach ECAs, PRI-Market, IFIs selectively and define stretch targets for structures
- Risk mitigants have their individual strengths and merits
- Using of mitigants including PRI is challenging but rewarding
- Regularly updated internal country rating system is mandatory

- a) Risk-adequate, competitive pricing of individual transactions
- b) Target-defined portfolio management
- c) Compatibility of tools offered by market participants will be a driving force for bank users ⇒ simplify application !

21

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22

Who is KfW IPEX-Bank?

- Leading German wholesale credit provider
- Part of KfW Bankengruppe
- Arranging, and participating in, export and trade finance, project finance, and corporate lending transactions including M&A
- 40+ years of experience – portfolio of EUR 64 billion
- Writing new business of EUR 8-12 billion per year
- Eight industry teams arrange and structure transactions
- Well-established product suite addressing requirements of European corporate customers

23

KfW IPEX-Bank and Export Credit and PRI

- Currently being transformed into a separate legal entity with full banking licence, starting 2008
- Losing privileges (state guarantee, tax exemption) and gaining scope (room for manoeuvre)
- Historically intensive user of ECA cover (up to 70% of emerging markets business ECA covered), broad range of ECAs (predominantly from Europe)
- Adapting product range and range of credit enhancement tools to our portfolio needs:
 - ECAs
 - Private PRI/TCI
 - IFIs (e.g. EIB, ADB, MIGA, etc.)
 - Local currency financing

24

Applying the requirements: ECAs



Robust procedures
for utilisation



Decade-long experience of cooperation

Cost-benefit ratio



Transparent pricing and reliable international
benchmarks; but more standardised buyer risk
premium required

Covers all types of
payments



Many ECAs cover only capital and interest

Flexibility of policy
language and
approach



Does not always exist due to state mandate and
OECD requirements; flexibility can be increased
by combination with other types of risk mitigants
e.g. investment insurance programmes (available
from some countries)

25

Applying the requirements: PRI



Capital treatment



Apart from challenging LGD calculation also lower capital
relief through higher risk weights of private insurers (as
opposed to official credit insurers)

Cost-benefit ratio



Seems fair for sovereign and quasi sovereign borrowers
(political and commercial risks overlap completely) – for
private borrowers determining benefits is not easy

Flexibility



No OECD rules; good tool for portfolio management
purposes

"Timely manner"



Is the standard 180-day waiting period "timely"?

Clearly documented



Generally stringent documentation and policy wording but
sometimes more exceptions than validations

Handling



Handling generally not an issue – once banks have
gained some market experience

26

Applying the requirements: IFIs

Capital treatment



LGD calculation challenging but benefits from excellent IFI rating; EIB good example for sovereign and sub-sovereign risk

Cost-benefit ratio



Seems fair for sovereign and quasi sovereign borrowers (political and commercial risks overlap completely) – for private borrowers determining benefits is not easy

Applicability



No restrictions under OECD rules but other headaches such as anchor loans

Flexibility



Seems generally not optimal although case-by-case approach is preferred

Handling



Generally a weakness, mostly risk mitigation is very deal-specific; sometimes strict internal rules make decision processes quite slow