

Publication date: 09-Apr-2001
Reprinted from RatingsDirect

Commentary

"B" Loans and Political Risk Insurance: Different Roads to the Same Destination

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"B" Loans and T&C Insurance

Summary

Lenders taking foreign-currency credit exposure to private-sector issuers in emerging market countries have long been concerned that foreign exchange controls might prevent these issuers from servicing their obligations. Two means of mitigating this risk—participations in loans made by select multilateral institutions (so-called "B" loans) and "political risk insurance" (or, more specifically, transfer and convertibility insurance)—have become more prominent since both were tailored to meet the requirements of the capital markets (see "How Preferred Creditor Support Enhances Ratings," RatingsDirect, June 15, 1999, also at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns; and "Political Risk Insurance May Enhance Emerging Market Structured Transactions," RatingsDirect, Nov. 2, 1999, also at www.standardandpoors.com under ResourceCenter-RatingsCriteria-StructuredFinance in Securitization in Latin America 2000).

Neither the "B" loan structure nor T&C insurance enhances the underlying creditworthiness of an issuer; consequently, neither elevates the local currency rating of the obligor. However, both can mitigate transfer and convertibility risk, allowing an obligation to receive a foreign currency rating as high as the issuer's local currency rating.

"B" Loans and T&C Insurance

Both means of mitigating sovereign risk are well established. The International Finance Corporation (IFC), the pioneer in developing the "B" loan structure, was making "B" loans in the 1970s, and the Inter-American Development Bank, the European Bank for Reconstruction and Development, and the Asian Development Bank have more recently established their own "B" loan programs. Under these structures, the multilateral institution makes a loan to a private-sector borrower in an emerging market country, thereby becoming the "lender of record," i.e., the sole contractual lender on the books of the borrower, with this status acknowledged by the government of the borrower's country. However, instead of maintaining all of the loan on its own books, the multilateral maintains only a portion—the "A" loan—and participates the remainder—the "B" loan—to commercial banks and/or institutional lenders, either directly or through a securitization.

Multilateral lending institutions have historically enjoyed treatment as so-called "preferred creditors." As such, not only have governments made foreign exchange available to private-sector issuers (with sufficient local currency) for servicing loans from these institutions while withholding it from these same issuers for servicing loans from other lenders; but they have provided that foreign exchange even while defaulting on their own foreign currency obligations. Carefully drafted documentation ensures, through pro rata sharing provisions, that both "A" and "B" loans receive identical treatment, so that there is no way to default on a "B" loan without also defaulting on an "A" loan. Therefore, if a government is to accord preferred creditor treatment to the multilateral lender's "A" loan, it must also do so to each participant's "B" loan, in effect passing on the preferred access to foreign exchange to nonpreferred-creditor lenders (placing them "under the umbrella" of the multilateral lender).

The first rated securitization of a "B" loan was done in 1995 by the IFC for Apasco, the Mexican cement company. The \$85 million portion of the IFC's \$100 million loan that was securitized received a foreign currency rating of 'BBB+', equal to Apasco's local currency rating and four notches above Mexico's 'BB' long-term foreign currency rating at the time. It was this transaction that brought the rating enhancement capabilities of the preferred creditor status of multilateral lenders to the attention of the capital markets.

Government-sponsored and some private insurers have been selling political risk insurance, including T&C insurance, for many years—the U.S. government's Overseas Private Investment Corporation (OPIC), for instance, has been underwriting political risk insurance since 1971. However, only in 1999 was the first rated capital markets transaction benefiting from transfer and convertibility insurance (from OPIC) completed, this being the placement of \$105 million of obligations of Otosan, the Ford-Koc Group joint venture automobile manufacturer domiciled in Turkey.

Standard & Poor's has rated numerous other "B" loan obligations. Last year, it rated the OPIC T&C-insured obligations of TGN, an Argentine gas pipeline company; a Multilateral Investment Guarantee Agency (MIGA, a member of the World Bank Group) T&C-insured pool of lease payments for medical equipment in Brazil; and an ACE Bermuda Insurance Ltd. T&C-insured sale of hydrocarbon royalty payments by the Argentine province of Salta. In all cases, the foreign currency ratings assigned were equal to the local currency sovereign credit ratings of the issuers, although this need not be the case. However, despite the equivalent ratings enhancement provided by "B" loan structures and T&C insurance to date, there are fundamental and important differences between them.

1. "B" loan enhancement stems from incentives for the government to provide the necessary foreign exchange; T&C insurance enhancement stems from the prospect of continued payment of debt service when a covered event of interference actually occurs.

The first distinction, critically important to those taking a strictly legal perspective, is the difference in the manner in which "B" loans and T&C insurance provide their sovereign risk mitigation. The country risk mitigation of the "B" loan structure depends completely upon the willingness and ability of a borrower's government to accord preferred creditor treatment in a time of severe financial stress and to provide foreign exchange so that loans made and participated by multilaterals may be serviced. If the government is unwilling or unable to do so, holders of "B" loans have no recourse to the multilateral lender or any third party. In such a situation, of course, the multilaterals, in addition to suffering the nonpayment of their "A" loans, also experience damage to their preferred creditor status. As a consequence, these institutions work diligently to ensure that foreign exchange is made available. For instance, the IFC, through its own operations and with the support of the World Bank, brings pressure on the borrower's government to meet its obligations. Nonetheless, had there been "B" loans to Iraqi borrowers outstanding in 1990, it is unlikely that participants would have benefited, since Iraq would in all likelihood have ceased to accord preferred creditor treatment to IFC following the invasion of Kuwait and the sanctions that were subsequently imposed, as it did to the World Bank.

It is also possible that a country otherwise disposed to respect preferred creditor status may find its foreign exchange position sufficiently dire that it makes the political decision not to meet its obligations to multilaterals, including the obligation to provide foreign exchange to private-sector borrowers with sufficient local currency to purchase foreign exchange at a rate reflective of severe financial stress. This appears to have been the case of Pakistan in 1998. While the government explicitly acknowledged IFC's

preferred creditor status, it argued that it simply did not have the foreign exchange to provide to borrowers from the IFC. Once negotiations for a new loan from the World Bank were completed in early 1999 the foreign exchange situation eased, and foreign exchange for the payment of all IFC obligations was quickly provided.

In rating the "B" loan obligations created by IFC, Standard & Poor's looked closely at the historical record of treatment of obligations to the IFC, which has been very good. To date, no IFC loan has been included in a general rescheduling of a country's debts, nor has IFC, or any participant in its loans, been requested to put up new money in the context of a general country debt rescheduling. Moreover, while there have been occasional sovereign-induced delays in servicing of IFC loans, these have ordinarily been short.

Standard & Poor's recognizes that there could be failures to accord preferred creditor treatment, and, as a consequence, always explicitly considers three factors in rating these transactions:

- The historical and expected future treatment of preferred creditor institutions by the government of the country of domicile of the borrower;
- Whether the current political regime has good relations with multilateral institutions and is integrated into the global trade and financial systems; and
- Whether debt to preferred creditor institutions—along with debt from structured finance transactions, which also may claim the most senior status—is an uncomfortably large percentage of external debt. In this regard, the multilaterals have generally demonstrated prudence in managing their preferred creditor exposure levels in individual countries and in aggregate.

By contrast, claims payments from a T&C insurance policy are made following an event of sovereign interference with the conversion of local currency to foreign currency or the transfer of that foreign currency abroad. As long as the terms of the policy are satisfied, payment depends entirely upon the willingness and ability of the T&C provider to pay claims in a timely manner and is not contingent upon the behavior of the government of the issuer. Thus, in the examples of both Iraq and Pakistan, assuming that the requirements of the policy and the claims process were satisfied and that the insurer was willing and able to meet its obligations, lenders would have received debt service payments in a timely manner up to the limit of the policy.

2. "B" loan enhancement covers all debt service and related payments; T&C insurance may only cover a portion.

By virtue of its lender-of-record status and the associated loan and participation agreements, all debt service and other transaction-related payments are typically made directly to the multilateral lender, including all payments destined for "B" loan participants. Accordingly, all payments including principal, interest, fees, and penalties enjoy the benefit of the institution's preferred creditor status.

By contrast, what payments and how much of these payments are covered by T&C insurance depends upon the terms of the policy, which can vary substantially from transaction to transaction. For instance, on the Otosan transaction mentioned above, OPIC insured 100% of principal and interest on the rated securities. However, in some subsequent transactions, insurance applicable to only a portion of total debt service has been proposed. Standard & Poor's criteria now permit the rating of a foreign currency obligation to be elevated, sometimes as high as the local currency rating of the obligor, even

when the insurance covers less than 100% of interest and principal (see "New Rating Approach Gives Private-Sector Issuers Credit for Partial Coverage of T&C Risk," RatingsDirect, Oct. 19, 2000; also available at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns). The degree of elevation will depend upon the country of domicile of the issuer, how much transfer and convertibility insurance is provided relative to the debt service payments, the pattern of debt service payments, the expected timing and duration of any sovereign interference, and the rating of the insurance provider.

3. Multilateral lenders are invariably concerned about the commercial success of the borrower; nonmultilateral insurers have little cause for concern.

While "B" loans may not enhance the underlying creditworthiness of an issuer, multilateral lenders have a different relationship with borrowers than do most insurers, particularly private-sector insurers, which some "B" loan participants value highly. A multilateral lender is invariably concerned with the commercial viability of the borrowers under its "B" loan program. Not only is the multilateral always a lender, and typically the largest single lender; but it also structures the transaction, negotiates the credit agreement with the borrower, and conducts the due diligence. As "B" loans become increasingly important to the multilaterals—and IFC's "B" loans, for instance, were larger than its own loan portfolio at end-June 1997 and 1998, although lower than that during the past two years—it is increasingly important for them to build and maintain strong relationships with participants, which are damaged when there are problems with timely repayment of "B" loans for commercial reasons.

More broadly, a multilateral has a long-term commitment to facilitate private-sector investment in the countries in which it operates. Should new government policies, a weakening regulatory environment, or a breach of government commitments imperil projects in which the multilateral is lending, a multilateral will use its influence with the government to overcome such problems. This can be an important factor in facilitating successful project implementation.

While multilateral providers of T&C insurance have similar broad concerns, other providers of T&C insurance have little at stake in the commercial viability of an issuer, since they lose nothing except premium income when an issuer defaults for commercial reasons. Their real concern is that the borrower's country of domicile not take action resulting in a claim under its T&C policy. Indeed, in a time of severe financial distress, when the probability of sovereign interference with payment of foreign currency obligations increases, the position of the insurer will actually be improved by the bankruptcy and liquidation of the borrower. This is because the insurer is not obligated to pay under its T&C policy if the borrower does not have local currency sufficient to purchase the foreign currency required to make its debt service payments.

4. If the issuer has the required local currency, the relevant willingness and ability to supply foreign exchange under a "B" loan is that of the borrower's government; with T&C insurance, it is that of the insurer.

The issues of willingness and ability to pay are qualitatively different for multilaterals and T&C insurance providers. In the case of "B" loans, multilaterals act only as intermediaries and not as providers of formal insurance to the "B" loan participants. The issues of willingness and ability to make foreign exchange available in a timely fashion to borrowers with sufficient local currency relate entirely to the sovereign, whose decisions are made in light of the preferred creditor status of the multilateral.

By contrast, the willingness and ability of providers of T&C insurance to pay in

a timely manner are key. Ability to pay is extremely strong in the case of OPIC—its obligations are backed by the full faith and credit of the U.S. government—and very strong for other bilateral official insurers from most highly rated countries or highly rated multilaterals. However, Standard & Poor's looks closely at not only the stand-alone financial strength of an official insurer, but also at the degree and manner of expected support from its government owners. The ability of a private insurer to pay claims is determined by its financial strength rating, and no transaction enhanced by T&C insurance from a private insurer will be rated without a rating of the insurer.

The ability to pay must be accompanied by the willingness to pay, and in a timely manner. The best evidence of willingness to pay is a long history of satisfactory claims paying behavior, such as that of OPIC. Moreover, OPIC has tailored its claims processing procedures explicitly to address the issue of timeliness, and Standard & Poor's is comfortable that a valid claim will be processed and paid in a manner consistent with the rating of the insured transaction. The claims-paying behavior of other long-active insurers—mostly official—would be subject to a similar review, as would the tailoring of their claims processing procedures. The absence of a long claims-paying history would require in-depth discussions with the senior management of the insurer and, if appropriate, its parent.

Two aspects of willingness that must be considered are those of policy exclusions and the insurer's approach to handling claims. T&C insurance is not a guarantee of timely payment, and claims are payable only if the requirements of the policy and other documentation have been satisfied. For instance, in the case of the OPIC insurance policy, grounds for denying payment of a claim could be the lack of a satisfactory effort by the insured to use all reasonable efforts to convert local currency and transfer it, or a finding that an unreasonable act by the insured was the primary cause of the sovereign interference. Similarly, the "company support agreement" between OPIC and the borrower includes covenants relating to corrupt practices, environmental matters, and worker rights, violation of which are grounds for the denial of a claim or the cancellation of the policy. In general, covenants of this nature seem more likely to appear in policies of official rather than private insurers, since they reflect the policy concerns of the government sponsor.

The second aspect of willingness to pay concerns the way certain issues relating to claims payments are handled and has been highlighted by recent experience with some providers of financial guarantees. The policies of so-called "monoline insurers"—companies whose only business is providing financial guarantees—are standardized to meet the requirements of the rating agencies with respect to timeliness of payment and the approach to disputed claims. In short, they are expected to pay on time and to challenge the claim later. However, recently more "multiline" insurers have begun issuing financial guarantees. In some of these institutions, the culture is one of paying a claim only after a challenge to that claim has been adjudicated—for instance, in the case of suspicion of fraud, monoline insurers are expected to make the scheduled payment and then pursue remedies, whereas some multiline policies allow the insurer the right to review a claim prior to paying and refuse payment if it feels that the claim is invalid. As a consequence, Standard & Poor's has determined that in some cases the willingness of a multiline insurance company to pay on a timely basis may be considerably weaker than its ability to pay. In light of this, Standard & Poor's has developed "financial enhancement ratings," which explicitly address both ability and willingness to pay (see "Criteria for Insurer Financial Enhancement Ratings Introduced," RatingsDirect, July 20, 2000). In all cases, a very close reading of all related documents and a clear understanding of exactly what is being insured are essential to the rating.

Summary

While "B" loan structures and T&C insurance can both elevate the foreign currency credit ratings of obligations of private-sector borrowers from emerging market countries as high as the borrowers' local currency credit ratings, they do so in very different ways. "B" loan structures ultimately rely upon the willingness and ability of the borrower's government to afford preferred creditor treatment to the multilateral providing the "B" loans; T&C insurance relies upon the willingness and ability of the insurer to pay in accord with the terms of its policy in a timely manner once sovereign interference has actually occurred. Insurance may cover only a portion of debt service payments, while "B" loans, by their nature, cover all payments. Insurance also generally introduces more documentary complexity, which must be assessed to determine whether difficulties could arise that would affect the ability to successfully claim under the insurance policy.

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