The Role of Country Risk in Crude Oil Trading

Bachelor Project submitted for the Bachelor of Science HES in Business Administration with a major in International Management

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Declaration

This Bachelor Project is submitted as part of the final examination requirements of the Geneva School of Business Administration, for obtaining the Bachelor of Science HES-SO in Business Administration, with major in International Management. The student accepts the terms of the confidentiality agreement if one has been signed. The use of any conclusions or recommendations made in the Bachelor Project, with no prejudice to their value, engages neither the responsibility of the author, nor the adviser to the Bachelor Project, nor the jury members nor the HEG.

"I attest that I have personally completed this work without using any sources other than those quoted in the bibliography."

Geneva, August 16th 2013

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Executive Summary

Crude oil is one of the foundations of the global economy. It is extracted in different parts of the world such as North and South America, Asia, Africa and Persian Gulf. It is a very important source of income for developing countries thus, disruptions of production due to geopolitical factors can be devastating for a country's economy.

This research is an attempt to understand the implications of country risk when crude oil is traded and find out what could be the solutions to mitigate this risk.

This study was developed through interviews conducted with a sample of ten people, composed of five traders and five bankers. During the meetings, participants discussed about their experience and impression.

Once the data is collected through interviews, they have been analyzed and synthesize for better understanding. The results are both obvious and surprising in some aspects. The reactions towards country risk can be different from on trader to the other, depending on their appetite for risk.

Contents

List of Tables

List of Graphs

1. Problematic

Is Country Risk the “raison d’être” of commodity trading companies?

1.1 Points to ponder

- What and who relate the concepts of country risk?
- Their current definition and how they are addressed by economic agents do they permit them to "risk" in foreign markets in the best conditions?
- Are the evaluations of country risk models actually used by traders? If so, which ones and how?

1.2 Scenario

Country risk analyses have been one of the major research topics within the economics and finance’s fields during the last years. However, this issue has almost been there since always. It has been omnipresent especially for crude oil since the first oil crisis when everybody realized that oil should not be taken for granted. Since then the oil market started to become volatile and sensitive to macro environmental events. The positive side of it is that people could benefit from these situations and have a better return. There was room to make money out of it and the profession of trader is born. Coincidence?

This work aims to understand the importance of country risk especially when it relates to crude oil trading and to learn about what techniques are being used to mitigate this risk if it is possible.

For this, first, a broad presentation of risks and more precisely Country risk will be developed in order to become familiar with the environment of the study. Then, the core of the report with the analytical part will be carried out through a phenomenology approach. Finally, a conclusion and will be made on the basis of the data analysis.

2. Introduction

The oil market, compared to other commodity markets, is complicated and involves a number of actors and specifications that are important to understand. It is a very strategic resource and one of the most important markets for the producing countries to generate a certain income. In one hand we have the consuming countries, such as the U.S. and European countries, also known by the developed countries and more recently countries such as China, India, Russia, etc. (BRICS) known to be the emerging markets, that have a particular interest in the oil market and its fluctuations because they need it to keep growing. On the other hand we have the producers such as Russia, countries in the Middle East and Africa. The U.S. is also an important producer but its production is for its own consumption. These producing countries, a part from the U.S., are often developing countries, where economical and political systems are very unstable and fragile mostly because of a lack in sovereignty. These countries are the centre of interest for this paper because it is where there is the highest probability for country risk.

Most of the concepts that will be addressed in this paper are relevant for commodity trading in general such as risks. However, they will be treated for crude oil reasoning.

2.1 Risks in Commodity and Trade Finance

Country risk is not the only risk a trader faces. We can count a total of fourteen risks related to Commodity and Trade Finance. Here is a table describing each risk and how to mitigate them, in order to acknowledge them and have a better understanding.

TABLE 1: RISKS IN CTF

Risks	Description	Mitigation
Bank	The risk to earnings or capital caused by a counterparty not being able or willing to fulfil its contractual obligations	• Credit analysis • Due diligence • Collateral • Sell risk to risk taker • Ultimate risk taker is government ("too big to fail")

Commodity's quality	The risk that a commodity does not meet contractual quality specifications or deteriorates in quality	• Commodity widely traded: known • Independent 3rd party inspection of commodity
Control / Title	The risk to earnings or capital caused by the inability to realise the value of a commodity used as collateral due to a lack of control over the collateral or as a result of faulty or defective title to the collateral	• Legal due diligence • Local law • Counterparty assessment
Counterparty (buyer/supplier)	The risk that a counterparty is unable or unwilling to perform its obligations undertaken by ~~its~~ entering into various contracts in pursuit of its business activities	• Credit risk assessment • Due diligence
Country	1. Insufficient foreign currency reserves 2. Legal and court system might not adequately protect the interests of foreign enterprises transacting business in the country 3. The country through its legislative, executive/administrative or judicial systems can interfere with or frustrate the performance of contracts entered into by its nationals 4. Political & social instability: government breakdowns, (civil) wars, insurrection, etc.	• Country risk assessment • Structuring transactions to reduce country risk • Collateral • Political risk insurance (Export Credit Agencies, private secor)
Credit	Credit risk is the current and prospective risk to earning or capital arising from a obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed	• Due diligence • Credit analysis • Structuring credit into performance risk • Collateral • Core competency of banks
Currency	The loss to the bank caused by an unfavourable change in the value in the currency mismatch of an underlying cash-flow vis-à-vis the currency in which the bank's credit facilities are denominated	• Avoid currency mismatches • Hedge

Fraud	The risk of loss to earnings or capital caused by a party's use of deception with the criminal intent to achieve financial gain at the expense of another party	• Policies and procedures to avoid fraud • Counterparty assessment • Training to detect fraud
Insurance	The risk of loss to earnings or capital in the event of the failure of an insurance to compensate for an insured loss	• Use competent insurance broker • Assess counterparty ability to manage policy • Legal advices • Credit risk of insurer
Market (price)	Risk resulting from the possibility that the price of a security or physical commodity may decline	• Hedging • Exchange traded commodities • Actively traded commodities
Operational	The risk of loss resulting from inadequate or failed internal processes, people and systems from external events	• Well defined policies and robust procedures • Strong internal controls • Separation of responsibilities
Performance	The risk to earnings or capital as a result of an entity failing to perform its duties and obligations it has contractually undertaken	• Assessment of counterparty's ability to perform
Reputation	Reputation risk is the current prospective impact on earnings and capital arising from negative public opinion	• Policies • Strategy • Know-your-customer
Shipping / Storage	The risk to earnings or capital caused by the loss of collateral either partial or total, during the shipping or storage of the collateral	• Assessment of shippers, agents, etc. • Assessment of storage facilities • Effective insurance

Source: PPT "Introduction to Structured Trade and Commodity Finance"

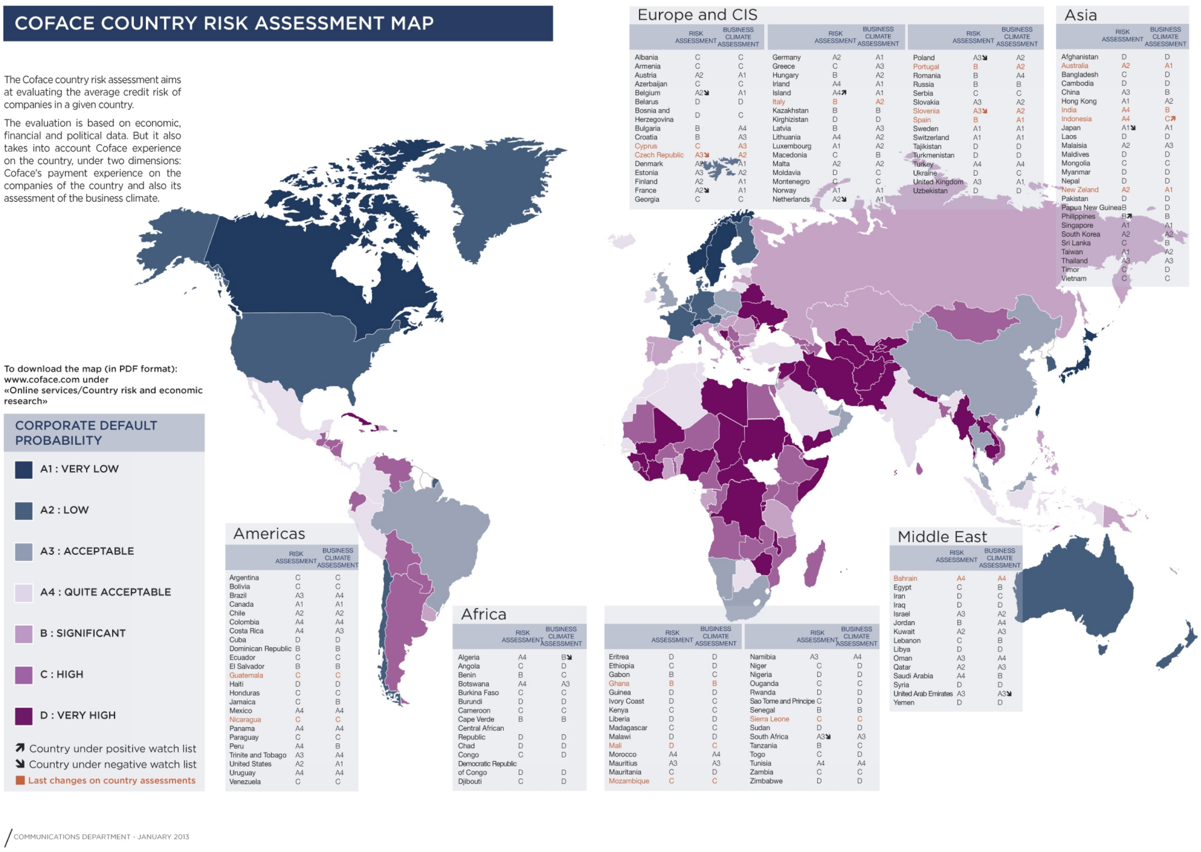
2.1.1 What Country Risk is and where it is

According to some researchers, Country Risk is defined as the probability that a country will default towards foreign creditors depending on changes in the business environment. Country Risk generally includes political risk, exchange rate risk, economic risk, sovereign risk and transfer risk. In other words, it is the risk of a capital being locked up or frozen by government actions. It is important to take Country Risk into consideration whenever investing or doing business abroad because it can considerably reduce the expected profit.

The U.S. is usually considered to be the benchmark for low Country risk, therefore, most countries have their risk measured and assessed compared to the U.S. Country risk. The variations from one country to the other are considerable at the point where some countries have enough high country risk to discourage most foreign investment.

Here is a graph of the world country risk assessment map from Coface. This map is available in the Appendix in a larger format.

GRAPH 1: COFACE COUNTRY RISK ASSESSMENT MAP



Source: COFACE

Coface asses the country risk of 157 countries and the results are freely available for consultation on their website. This assessment indicates to what extent a financial commitment of a company can be influenced by economic, financial and political factors of the country concerned. The grades are assessed from A (very low risk) to D (very high risk). A detailed description of the countries' evaluations is available in the Appendix. In this graph, we can see that the countries with higher country risk are mainly in Africa and Middle East. In parallel, it is also the countries where the majority of oil is produced and exported.

According to the U.S. Energy Information Administration (EIA), the top ten net exporters of crude oil in 2011 was Saudi Arabia, Russia, United Arab Emirates, Kuwait, Nigeria, Iran, Iraq, Angola, Algeria and Qatar and paradoxically, those countries have ratings from “very high” to “quite acceptable” default probability due to country risk.

2.2 Country Risk evaluation models

Many institutions are dedicated to the analysis of country risk such as Coface mentioned above. They base their analysis on three fundamental factors like the economic, the financial and the political factors. However, not all of them use necessarily the same approach and methods. That is why reports end up with some differentials in their results. Here is a presentation of three major country risk analysis institutions.

2.2.1 Coface

Coface[1] (Companie française d’assurance pour le commerce extérieur) is a French companie specialized in insurances and credit insurances for exportations. It was founded in 1946 and it is represented nowadays in sixty-six countries.

Their assessments are based on a triple expertise developed by Coface, which consists:

1) Macroeconomic expertise in assessing country risk through a battery of financial indicators and macroeconomic policies.
2) Expertise on the business environment. The assessment is calculated both from internal and external sources.
3) Microeconomic expertise that draws on its database of 44 million companies worldwide and 50 years of experience in payment flows.

However, their international traders know that there may be good companies in bad counties and bad companies in good countries, therefore, their analysis not only takes into account the specifics of the country but also those of the companies operating locally.

[1] COFACE. http://www.coface.fr/CofacePortal/FR_fr_FR/pages/home/os/risks_home/risques_pays

2.2.2 The PRS Group

The PRS Group[2] (Political Risk Services) is a worldwide system for quantifying and rating political risk. It has been developed by Professors W.D. Coplin and M.K. O'Leary for twenty years in Syracuse University and became independent in 1999. In 1992, The PRS company added the "International Country Risk Guide (ICRG)" system to its offerings. The ICRG is the methodology I am focusing in.

Basically, ICRG methodology is divided in three categories.

Political Risk index that consists of twelve weighted variable covering political and social attributes.

Financial Risk aims to assess a country's ability to pay by assigning points according to the country's foreign debt, current account of exports and imports, exchange rate stability, etc.

Economic Risk consists of assessing a country's current economic strengths and weaknesses by assigning points according to the GDP, the annual Inflation Rate, etc.

2.2.3 Standard & Poor's

Standard & Poor's (S&P) is an American company that publishes financial research and analysis on stocks and bonds. They also have a rating service on more than a million companies and sovereignties. Their experience in the business for more than 150 years makes them one of the world's leading providers of independent credit risk research and benchmarks. Their ratings are expressed with letters that range from AAA (very low risk) to D (very high risk)

For the sovereign rating, S&P analyses five key factors that are:

1) Institutional And Governance Effectiveness Score, which includes the effectiveness, the stability, the transparency, etc. of the sovereign's policymaking

2) Economic Score, which includes income levels, growth prospects and economic diversity and volatility

3) External Score, which includes the local currency in international transactions, the country's external liquidity and external position.

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[2] PRS Group. http://www.prsgroup.com/ICRG_Methodology.aspx

4) Fiscal Score, which is separated into two segments, “fiscal performance and flexibility” and “debt burden”

5) Monetary Score, which includes the country’s ability to coordinate and the credibility of monetary policy and the ability to support sustainable economic growth.

2.3 ***Historical conflicts vs. oil prices***

Before the first oil crisis in 1973, the oil market was stable and the prices of Arabian Light ranged between 15 and 25 USD. The first oil crisis doubled the oil price to 50 USD approximately because of the OAPEC oil embargo, which lasted until March 1974. This embargo was a response to the U.S. decision of supplying Israel with arms while Egypt and Syria, supported by other Arab countries, were attacking Israel. Graph 2 bellow, shows the oil price history in order to have a better understanding on geopolitical effects on oil prices.

In 1979, the second oil crisis began in reaction of the Iranian Revolution. The strikes and protests reduced considerably the Iranian production from 6 million bbl/day to 1.5 million bbl/day. This decrease in supply added to the decision of U.S. President Jimmy Carter to stop Iranian imports caused a rise in oil prices. As we can see on Graph 2, oil prices reached 100 USD for the first time in hundred years.

In the 80s, the oil market was shaken again because of the Iran-Iraq war, two major oil producers. However the prices dropped considerably after the 1979 crisis until 1990, Iraq invaded Kuwait. The consequences of this war were again the rise in oil prices reaching more than 40 USD because of the destruction of hundreds Kuwaiti oil wells.

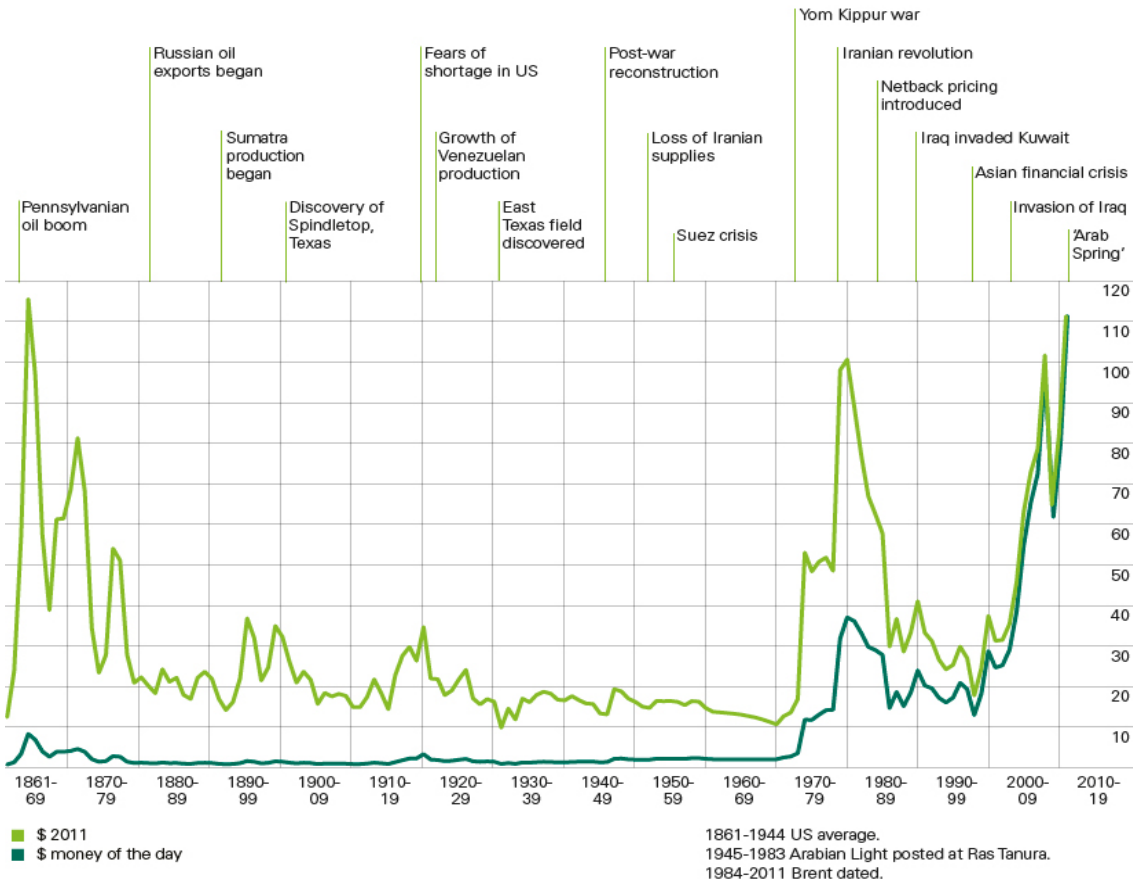
The Asian crisis, which started with Thailand in 1997, affected many other Asian countries such as Indonesia, South Korea, Malaysia, etc. The crisis had important macroeconomic-level effects including the reduction in currencies values, stock markets, as well as a sharply reduction of the oil prices dropping to bellow 20 USD.

Then came the Invasion of Iraq in 2003, by the U.S. According to the previous U.S. President George W. Bush and the former British Prime Minister Tony Blair, the reason to attack Iraq was to destroy their weapons and to end Saddam Hussein dictatorship to free the Iraqi people. Now in retrospect, many people believe that it was just a question of controlling the Iraqi wells. At that time the oil price rose to more than 100 USD.

In 2007, the financial crisis resulted in the collapse of large financial institutions and downturns in stock markets all around the world. Every market was affected including the oil market. Crude oil prices dropped to approximately 60 USD.

Finally, the Arab Spring, which started in 2010 with Tunisia, followed by Egypt, Libya, Syria, Algeria, etc. obviously impacted the oil market and still is because the tensions in Syria, Egypt, etc. are not over yet. The oil price is currently around 107 USD and it is difficult to predict how it is going to change, although the futures market for both WTI and Brent are in backwardation revelling a bearish oil market.

GRAPH 2: OIL PRICE HISTORY

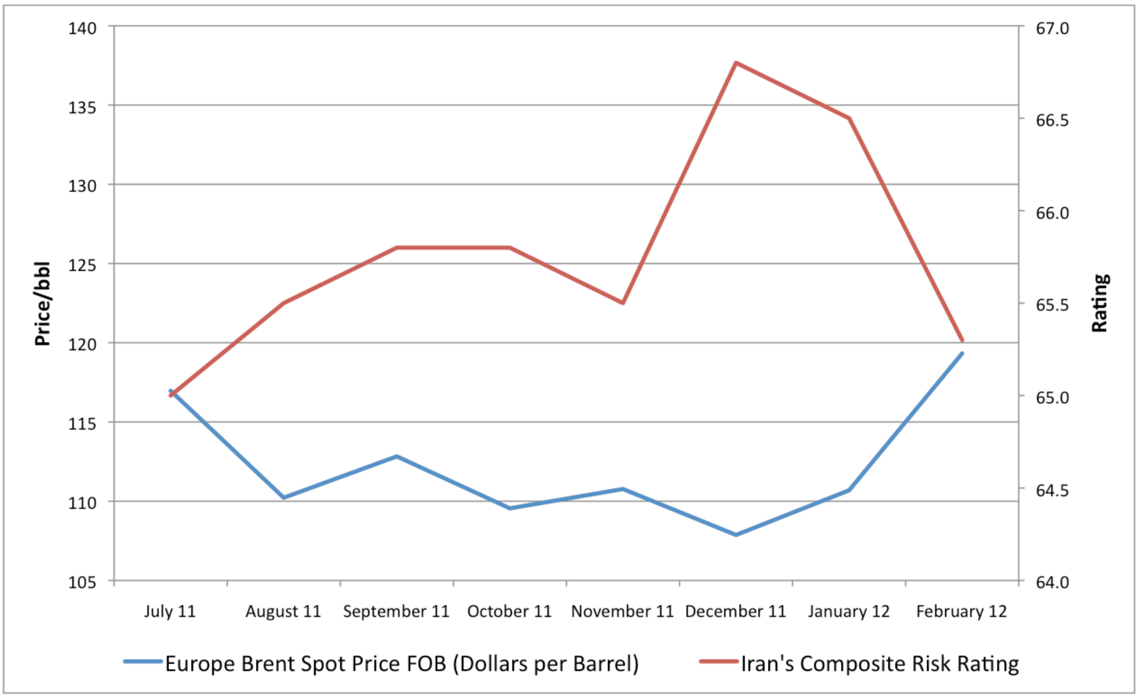


Source: BP Statistical Review of World Energy June 2012

2.3.1 Country risk vs oil prices

We already know that extreme events such as wars, revolutions, changes in government, etc. have an impact on country risk ratings. We also know that crude oil coming from Middle East and North African countries are priced on Brent's benchmark, meaning that those countries' production have a direct impact on Brent's quotations. The examination I would like to make is to analyse the correlation between country risk ratings and crude oil prices. For the purpose of this study, I chose to focus on Iran. The ratings are provided by ICRG and the prices for Brent's benchmark are obtained from the Energy Information Administration of the U.S. Department of Energy (EIA).

GRAPH 3: CORRELATION IRAN'S COUNTRY RISK RATING AND BRENT SPOT PRICE



Source: ICRG and EIA

To understand this graph, one should know that the higher the rating, the less risky it is and inversely (Rating 100 = extremely low risk; Rating 0 = extremely high risk). Therefore, we can see above that when the country risk is getting lower from July 2011 to October 2011 the Brent price is also decreasing. And from December 2011 to February 2012, Iran's country risk is increasing and so is Brent's price.

I will go now in the "Development" part of the work where the methodology I used is described.

3. Development

3.1 The methodology adopted

The methodology used is the phenomenological research, which describes the meaning for several individuals of their lived experiences of a concept or phenomenon.

In this case, the individuals are commodity traders that are involved in crude oil trading and bankers that finance crude oil transactions.

For this method, the tool used to collect data is semi-structured interviews.

3.1.1 The semi-structured interview

The semi-structured interview is frequently used to collect qualitative data set by the interviewee directly on the ground. This type of interview is used to retrieve the subjective information, opinions based on the experience of the respondent. The interviewer will conduct the interview in part and apply that each theme is addressed.

Unlike a purely structured interview, there are no rigid rules in order to answer the questions, in the sense that the speaker asks the question and/or evokes a theme to the respondent and he provides all knowledge on the subject. It is important not to be too prescriptive and allow time for the interviewee to speak.

To achieve this type of survey, the course takes place in four phases:

Phase 1: An interview guide/questionnaire is defined in terms of themes and topics that questioning would like to address, discuss and deepen with the questioning.

Phase 2: Once the guide has been developed, it must select the sample with which the survey will be conducted. The size can be between ten and twenty interviews with various individuals to obtain relevant information. In my case, my sample size is ten, five interviews with commodity traders and five interviews with bankers working in trade finance.

Phase 3: The interviews are conducted in the field. The investigator explained the reason and prior issues of the questions, then presents the different topics / issues. In my case, I went to the banks and trading companies to meet the interviewees and then explained the purpose of my work and started the interviews based on the questionnaire. Due to technical issues, two interviews were conducted over the phone.

Phase 4: Once the information has been collected, proceed to analyze them and interpret them. In my case, once the analysis done, I have made some recommendations and a conclusion in relation to the research conducted.

In summary, these interviews help me to have the necessary information regarding the concepts of country risk.

3.1.2 The sample selection

Commodity traders selection

For confidentiality purposes, no names will be mentioned in this report but I can assure that every interviewee works or had worked in commodity trading companies such as Cargill, Socar, Mercuria, etc. I had the opportunity to meet them previously in my Commodity Trading class the past two semesters, so I had the chance to already have some contacts. And luckily, once the first commodity traders interviewed, I could count on their help to provide me other contacts to carry on my research. Ultimately, the interviews have been completed in about two weeks for the commodity traders' selection.

Bankers selection

As for the commodity traders, I will not mention the bankers' name in this report, but again, I can assure that every interviewee works or had worked in banks involved in trade finance such as BNP Parisbas, BCGE, ING, etc. My contacts came mainly from the help of previous interviews with commodity traders and also from my own network. The interviews were conducted over several days, depending on the availability of those people involved.

3.1.3 The questionnaire

All the questions asked relate to country risk in crude oil trading. There were eight questions in total and all of them aimed the interviewees to tell about their own experience, therefore the majority of opinions are subjective.

Here is an overview of the questionnaire:

1. How important is Country risk for you?

- This question aims to pounder the importance of country risk for a trader compared with other risks one may face.

2. How do you inform yourself about the Country risk of a country?

    - This question allows to know the different techniques a trader uses to always be informed.

3. If the Country risk is considered too large, what do you do?

    - This question allows to know what a trader can do in order to mitigate the risk and also to know what is considered too large, meaning the level of risk a trader can take.

4. How much you think is the percentage of loss in your company due to Country risk?

    - This question aims to know, although Country risk is in the mouth of everyone, does it actually arm trading companies as much as we read it in the news?

5. What were the impacts of Middle East conflicts such as Gulf Wars, Arab Spring, etc. for you?

    - With this question, I am looking for real stories that the trader had experienced, and how they managed the situation.

6. Do you use evaluation of country risk models? Which ones? How?

    - With this question, I am looking to see if traders use country risk analysis organizations such as The PRS Group, ONDD, etc.

7. Can you measure how useful the models were in taking decisions?

    - This question goes with the previous one. If traders rely on those models and how useful and relevant they are.

8. Who takes the decisions?

    - This question allows to understand how the company operates vis-à-vis a risky transaction. Also to know who finally takes the responsibility for transactions that might fail.

3.2 ***Profiles' descriptions***

As mentioned in the previous section on the methodology used, the necessary information was obtained through interviews with traders and bankers. The main criteria for the choice of the interviewees are for the traders to be involved in crude oil trading and for the bankers to work in banks that finance commodity trading companies and specially crude oil trading transactions.

For privacy reasons, nothing but their initials will appear in this report.

Commodity traders

1) Trader A.M.

A.M. is employed by a commodity trading company headquarted in Azerbaijan. He works in a branch in Geneva for more than three years but had previously worked for thee years in another trading company also as Crude Oil Trader. He's about thirty years old and already has a solid experience in Commodity Trading.

It was interesting for me to interview him because he is young and dynamic. Having the perspective of a person of this age intrigued me, knowing that he has the same responsibilities as a trader a little older.

2) Trader D.W.

D.W. is employed by an internationally well-known American commodity trading company for more than eight years. Previously working in its headquarters in USA, he has been working for a branch in Geneva for the past two years.

As A.M., D.W. is about thirty years old but besides his experience in crude oil trading, he also worked in the grain market, which makes it interesting for me to have is point of view regarding Country Risk not only in crude oil but also the comparison with agricultural products.

3) Trader J.L.

J.L. is employed by a trading company specialized in marine fuel supply headquarted in Danemark. She has been working for a branch in Geneva for two years. She had previously worked for a famous inspection company and studied Commodity Trading at the University. She's about twenty-five years old.

4) Trader R.P.

R.P. had worked for several years in different Commodity Trading companies. He has more than 25 years of experience in Trade Finance, Structured Commodity Finance, Trade Credit and Political Risk Insurance. He is currently lecturer of Commodity Trading & Finance courses in a Business School in Geneva. He's about sixty years old.

I chose him for his long-term expertise in the field and his depth knowledge of Commodity Trading and specially Trade Finance.

5) Trader J.T.

J.T. has several years of experience in Commodity trading. He had worked for different trading companies and inspection companies. He is currently working for the second most famous inspection company in Geneva. His experience in fuels and biofuels, which are closely related to crude oil makes him someone interesting to interview in order to have a comparison of those products when Country Risk is involved.

<u>Bankers</u>

1) Banker D.H.

D.H. is currently the Team Head Commodity Finance in a well-known French bank. He has been working for twenty years in a branch in Geneva. Previously, he had worked for a famous Swiss bank in Geneva. His knowledge in Trade Finance and the bank he is working for, which is a bank very involved in financing Commodity Trading, makes him a very interesting person to interview.

2) Banker P.Z.

P.Z. is currently the director of is own consulting company that he founded a year ago. Previously, he had worked in a well-known bank headquarted in France. He had worked for thirteen years in a branch in Geneva. He had also worked in another Dutch Bank in Geneva for six years as Head of Commodity Finance.

His expertise in the field allowed him to create his own consulting company for clients interested in commodity finance investment. I chose him for his depth knowledge of Energy products and Trade Finance.

3) Banker S.Z.

S.Z. has more than twenty years of experience in Commodity Trading especially in Oil related business and Trade Finance. He worked several years in different large Trading companies especially involved in Crude Oil and other energy products. He is currently director of an International Oil and Coal Trading Company. Besides that, he is also lecturer at the University for Commodity Trading courses.

Therefore, his views and his vision on the filed could only be rewarding for my analysis.

4) Banker Y.B.

Y.B. is a young finance specialist of 34 years old working in Geneva for a branch of a famous Dutch Bank. He has a master in finance and acquired experience in commodity trading in another Swiss bank based in Lausanne. He has been working in trade finance for five years and he is currently occupying a country risk analyst at the Dutch bank.

His experience and openness in the topic regarding his bank helped me to better understand how a bank works when traders ask for financing transactions.

5) Banker S.C.

S.C. is the Vice President of the Head of Energy & Softs. He has been working in Trade Finance for more than 14 years in a Swiss bank based in Geneva. Previously, he has worked as trader for about 9 years in two different Commodity Trading companies here in Geneva.

He was a very interesting person to interview because of his experience once as the client (trader) who asks for funding and once as the banker who gives funding.

3.3 Interviews Examples

All transcripts of the interviews are available in the Appendix section, nevertheless, here are two that I found interesting to share in this section, one with trader A.M. and the other with the banker P.Z.

Trader A.M.

Age: 30-35 Gender: M

1. How important for you is country risk regarding commodity trading?

Very important because it can be one reason for the banks not to finance your transactions and you don't usually pay with the company money so you loose the business. For instance banks don't do open account for Israel so it's difficult to do business in this country.

Country risk is also important to take into account because of insurances issues.

2. How do you inform yourself about the country risk of a country?

By being on the field. But this takes time (approximately two years to open a branch in a new country). Communication is very important, always talking to people to try to be the first ones to get information.

3. If the country risk is considered too large, what do you do?

A part from not dealing with this country you can't do much. Some people pay bribes to be closer to the government but it is not our policy. We currently have one case in Egypt. Some of our crude is refined there and because of the change of regime, they don't allow us to get our crude back and we have for approximately 100'000'000 of lost crude. For now we're still waiting, negotiating and trying to find compromises.

4. How much you think the percentage of loss due to country risk?

I don't know exactly but I would say that only 1% of our transactions occurred to have some complications. Which is a sense is good because it encourages us to take more precautions for the following ones.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

The story of our crude trapped in the Egyptian refinery.

6. Do you use evaluation of country risk models? Which ones? How?

No, because you don't need them. You use your network to be informed.

7. Can you measure how useful the models were in taking decisions?

Not useful

8. Who takes the decisions?

Usually it is the manager depending on the transaction. In our branch, we are three people trading energy products and at least two of us must agree in order to do the transaction.

Banker D.H.

Age: 50-55 Gender: M

1. How important for you is country risk regarding commodity trading?

This is very important. Today Country risk must be qualified in two categories: pure country risk and compliance risk.

Traders buy where they can as long as prices are interesting. They do not care too much about the country risk, they pass the baby to the bank and the bank is in charge of managing country risk.

Because of Country risk, our bank no longer trades with Syria and for example some problems in Sudan makes it difficult to trade because of the differentials between north and south

2. How do you inform yourself about the country risk of a country?

I read specialized media such as FT, Bloomberg, etc. I also read publications by Platts, Marketwire, Argus, etc. But the most effective way to keep up to date is to talk to your local people if the bank as a branch in the country concerned.

However, I would be careful with direct contacts with people from governments because it is not always accurate since they tell what is best on their behalf. I would rather talk to maritme people or inspection companies than talking to someone in the government. They should be fairer.

3. If the country risk is considered too large, what do you do?

Credit lines are assigned by the bank for each country, meaning that the bank decides how much maximum risk they are willing to take for each country. This is called Country Envelope. If it is too risky and the Envelope for this country has already been enough used, we ask our client to take an insurance.

The bank also contracts insurances but we have to do it discretely and informally because it could encourage the client to default.

4. How much you think the percentage of loss due to country risk?

I can't tell you a number. What we do is a back testing for each transaction, meaning that if a transaction goes wrong we watch it carefully and the transaction goes into a "watch list". Usually when something bad happens the only solution is to extend the repayment deadlines. But since Crude Oil is so important for a country especially for a developing one, people prioritized their expenses and the company ends up by paying even with some delays, otherwise they know that we won't be dealing with them anymore.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a banker?

Before that, there was less pre-financing therefore less risk. Prepayments are fairly recent. Our bank is not a risk taker. When those events occurred, we were still doing transactions because anyway everyone knows that crude oil is the last thing to be impacted because any government will do its utmost to run its oil industry.

We had some issues in Egypt because they stopped the Sumed pipeline but we found a way to get around it and the crude could finally be delivered.

Regarding the current embargo on Iran, our bank absolutely complies with the sanctions because compliance and reputation risk is our top priorities.

6. Do you use evaluation of country risk models? Which ones? How?

Our branch in Geneva does not do evaluation of country risks but the headquarter does. I don't know exactly which ones they use if they use any. But here in Geneva we receive everyday the reports our analysts made and we carefully read them and take into consideration.

7. Can you measure how useful the models were in taking decisions?

I don't think they are much useful because there is always a lag between the analysis and its publication. Therefore, it might be accurate enough by the time we receive and read them

8. Who takes the decisions?

The transactions go to the Credit committee and the chief group must consult its supervisors, he can't take the decision by himself. We have a whole process to follow and it is the Credit committee to decide after presentation of the transaction.

4. Analysis

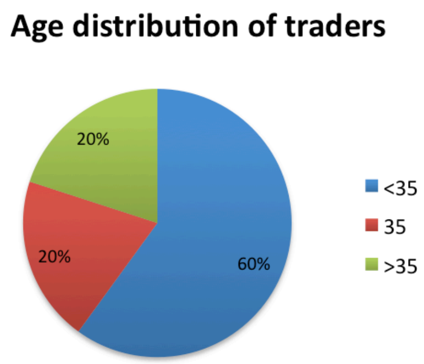
4.1 Data analysis by figures

4.1.1 The age of the sample

⇒ Average age of 45 years old and a median at 43 (traders and bankers together)

Traders

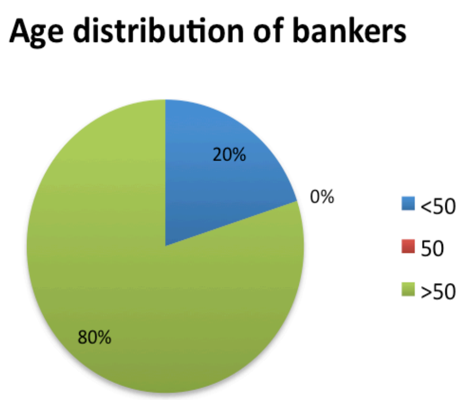
The average traders' age is around 38 years old and the median is 34 meaning that 50% of traders are younger than 34 and 50% of traders are older than 34. According to the pie chart, we can notice than 60% of traders are younger than 35 years old. Although I tried to have interviews with various age groups, it is in fact very common to see in the trading environment many young people.



GRAPH 4: AGE DISTRIBUTION OF TRADERS

Bankers

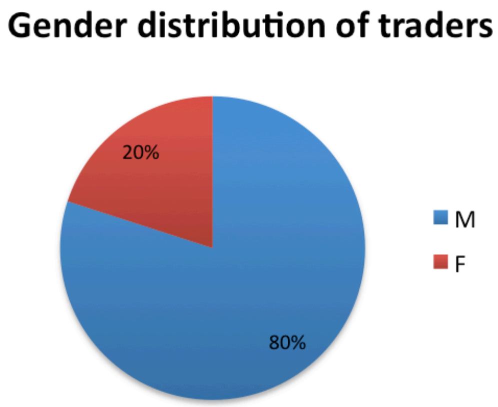
The average bankers' age is around 52 years old and the median is 54 years old. We can notice than 80% of bankers are older than 50 years old. Again, as for the traders, I tried to have interviews with various age groups in order to have different experiences, but it is in fact very common to see in the banking sector older people because they need to acquire experience, moreover, the majority of the bankers interviewed were Presidents or Vice-Presidents of their department.



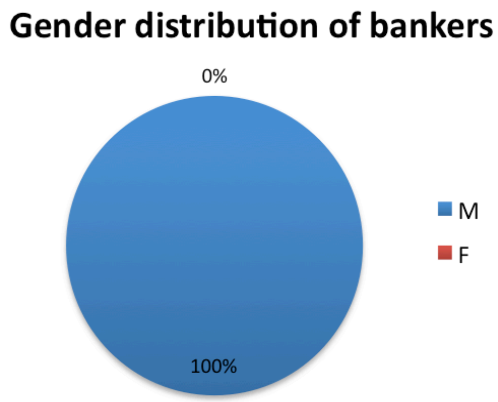
GRAPH 5: AGE DISTRIBUTION OF BANKERS

4.1.2 The gender of the sample

Regarding the gender of the interviewees, out of ten people, only one person is a woman. It is indeed not very surprising because the trading and bank sector are famous to be a male environment especially when it relates to high positions. The proportion of women among the employees of Swiss banks is 43% and a very few in high-level positions[3].



GRAPH 6: GENDER DISTRIBUTION OF TRADERS



GRAPH 7: GENDER DISTRIBUTION OF BANKERS

4.1.3 The experience of the sample

⇒ The sample has at least an university education

All the traders and bankers interviewed had an academic background at a university level. Regarding the professional experience, it varies from a person to the other.

In general, most of the bankers interviewed had more than 20 years of experience in the domain. This explains also why they occupy high-level positions in their respective banks. Regarding the traders, their experience in commodity trading varies mostly because of their age. The younger ones have a professional experience from 2 to 10 years and the older ones for more than 20 years.

[3] ASEB. www.aseb.ch/themes/egalite-entre-femme-et-hommes/

4.2 Data analysis by themes

According to the results of the interviews, I have grouped the data analysis in for themes in order to obtain relevant facts vis-à-vis the research topic. Information is gathered and synthesized to ensure readability and understanding.

These are the themes developed in the following sections.

⇒ 4.2.1. Importance of country risk

⇒ 4.2.2. Information and communication

⇒ 4.2.3. Evaluation models

⇒ 4.2.4. Decision power and responsibilities

4.2.1 Importance of country risk

My first question to the interviewees was about the importance of country risk. As explained in the introduction part, a trader faces many different risks but it is interesting to understand the different perceptions of country risk from two sides of the transaction, the trader, who see the opportunity, and the banker, who provides the funding.

Here unanimously, interviewees said that it was very important. All of them had the same answer but raised different points to explain why it is important.

Traders

A couple of traders mentioned the fact that transactions facing country risk must be taken very carefully but it is also the opportunity to make more returns. Indeed, if a trader sees an opportunity in a country where country risk is high, he can have better chances to have no competition because other trading companies would not dare to do business with the country in question. As a result, the trader can have better prices for a crude that usually worth much more and then sell it at market value and generate a profit superior than anybody else. Of course this assumption is in best case scenario, meaning that the trader manage to take the product loaded and therefore out of the country's conflict situation. Generally, this situation could happen in large trading companies such as Glencore. Vitol or Trafigura, companies that have the means to finance the transactions themselves. Not forgetting that these big companies often have stricter rules towards risk taking and the transactions must be controlled and approved by different departments and hierarchical levels. So then we can think that it is also according to the traders themselves. Some interviewees talked about "crazy traders" that had no shame to take on huge risks for the trading company because all they think about is their bonus at the end of the year. Quote: "It is even better than gambling because they are not betting their pocket money anyway". It is true, but that is why most of the time the transactions must be approved by many different people provided that it is in the company's risk policy. However, all of the interviewed traders were reluctant about their willingness to take on risk just to make more money than the others.

Another point raised by some interviewees is the impact of extreme events on the operational side. For instance an unpredicted civil war in Singapore could affect the routes one has planned for its cargo or the place of his storage facilities. All this can give a hard time to a trader to achieve his goals without delays or putting on more costs.

To the questions "what would you do if it is too risky?" all of them answered reasonably by saying that they would withdraw and cancel the transaction. Some trading companies work with the Value at Risk system (VAR), which is a method to calculate the odds of losing money[4]. According to their VAR, they know how much risk they can take on and if it is above the limit allowed they do not carry out the transaction. Another reason, which prevents traders to carry out a transaction with high country risk, is the bankers' disapproval. As stated earlier, trading companies rarely finance their transactions themselves. The majority of the interviewees mentioned the role of banks in deciding whether or not to execute the deal, simply because the banks could refuse to finance it. And this brings me to the next point, the bankers' opinion.

Bankers

One of the biggest concerns for the banks is to not be paid when dealing with countries with high country risk levels. Indeed, when a country is in a difficult situation, most of the businesses are idling. For example when the politician Muammar Gaddafi was captured and killed by the National Transitional Council (NTC) rebels in 2011, Libya was left out without official governor. As a result, the NTC rebels were controlling a considerable part of the Libyan crude production. Vitol took position in this change in government and started to trade with the rebels. But in May 2011, attacks on the Libyan oil fields interrupted the oil flow leaving the rebels with a debt of more than 500 million USD towards Vitol[5]. In general, banks take measures when there are political

[4] Investopedia. http://www.investopedia.com/articles/04/092904.asp

[5] FT. http://www.ft.com/intl/cms/s/0/93aecc44-d6f3-11e0-bc73-00144feabdc0.html#axzz2c4vYWtHE

instabilities, for instance, some banks do not do open account for Israeli banks. Or they do not do prepayments anymore. A couple of bankers talked about the importance they attach to country risk compare to the traders. “They do not care too much about the country risk, they pass the baby to the bank and the bank is in charge of managing country risk.” To do so, banks do not hesitate to add a sort of additional interest to the money they lend for the transaction. It is called time country risk (TCR) and it is a flat rate of 4 to 6 percent depending on the level of country risk.

A current difficult situation is the trade of Iranian oil. The actual banned imposed by the U.S. on Iran, put the crude oil trade very difficult. Not only because of the embargo on Iranian exports but also the obstruction to U.S. dollars. Thus even if someone manages to buy Iranian oil and to export it, they will hardly manage to be paid due to the fact that the currency for commodities is U.S. dollars and the Iranians have restricted access to it, unless the bank accepts to be paid in Iranian rials, which is very unlikely.

The banking system for approbation of credits when country risk is concerned is in the form of credit lines (envelopes). Each country has a credit line assigned, which defines the maximum amount the bank is willing to spend annually for a particular country i.e. if the envelop for Spain is 10 millions, the department of trade finance can finance transaction up to this amount. It is like a budget and the bankers choose on which transactions they allocate the money. Those credit lines are defined for each country according to its country risk and are subjected to changes at anytime. For countries such as Germany or UK the credit line can reach hundred of billions because they know that those countries are very unlikely to default so the banks will never lose money. On the other side, countries with high country risk ratings have very limited credit lines. For instance, at the moment, some banks decided to have zero credit lines for transactions dealing with Iran. In general there are three scenarios when a trader comes to the bank asking for funding. First, the bankers working in trade finance look up on how much credit line is left for the country where the transaction is done, if there is enough money to finance this transaction, they will study the case in order to define if it is worth it and then accept it or not. Second scenario, there is not enough money left in the envelope but after study of the case the bankers really believe that it is worth it and ask the Credit Committee to extend the credit line. The credit committee either accepts it or not. Last scenario, the credit line is exhausted and the case is not worth it so they decline the client’s proposition.

4.2.2 Information and communication

To the question “how do you inform yourself about the country risk of a country?”, all the interviewees replied practically the same. Whether it is traders or bankers, all read a lot of newspapers, specialized magazines and publications, such as the Economist, Financial Times, Marketwire, etc. But all agreed on one point, which is the communication among people related to the business. Whether it is their colleagues, the suppliers, their bankers, or even the shipmaster, talking to people is the most effective way to keep up to date on what is happening and what is going to happen. However, the majority mentioned the fact of being careful with the source of the information. For instance newspapers, as much as they try to be objective, they very often take a side to the story therefore, one should be vigilant on what to believe or not. Same for the people in their network, it is very important to know with whom you are talking with, is he truthful or not? One banker also talked about the direct contacts with government members, which can be rather difficult because of their reliability. Indeed, people working for the governments often tell only what is in their best interest.

Most of the large companies have their own risk analysis department, where the only job of the analyst is to get the best information they can. To do so, they travel a lot in order to meet the people, to see the situation, to go to the plants, the fields, the storage facilities and talk to the staff. They are constantly on the lookout for good information because knows the information first is the one who grabs the opportunity and therefore make money.

4.2.3 Evaluation models

Here, the data show two different types of response, the traders’ attitude towards country risk evaluation models and the bankers’.

<u>Traders</u>

Almost all the interviewees claim not using any evaluation models and different reasons were explained. Some raised the problem of the reliability of these models. They are afraid that the information used to establish the reports is coming from poor sources especially the reports freely available for open consultation. And even the reports you pay for sometime can be doubtful. Quote “Nothing guarantees you that these guys have not just use Google to get their information.”. According to them, sometimes one is better off by getting the information himself by people he trusts and knows that in order to find the information they had actually been on the field and had seen the real situation of the country in question.

Another argument against evaluation models is that they cannot help at a contractual level. Reports showing a country with rating "D" (very high risk) do not necessarily mean that one should not do business in this country. They can be good companies in bad countries as well as bad companies in good countries. Evaluation models cannot show for a particular transaction if it is going to fail or not and usually only the experience does.

Bankers

The majority of the bankers interviewed had different opinions regarding evaluation models. Some of them claim not using it for the same reasons as the traders. Quote: "I don't trust so much these models because we have a better understanding on the subject than them. (…) We prefer to ask our own analysts.". The others mentioned that these models are used, not necessarily by them, but rather by the bank's risk analyses department. In general, the banks do their proper country risk analysis on which they grant greater emphasis. They consult S&P's, for example, but just for comparison.

However, the majority declare reading their bank's reports carefully and taking it into consideration when doing their job. The rest still think that the reports are not so useful because of the time lag between the country analysis and the publication of the report. The information can simply be not relevant anymore.

4.2.4 Decision power and responsibilities

Regarding the final decision of doing risky transactions, the process is not so different from traders to bankers. They all eventually require permissions to their superiors.

Traders

In general, the decision-making power returns to the top of the hierarchical pyramid. When traders see an opportunity that is risky, they will try to gather the maximum information on the circumstances of the transaction. They will also calculate the VAR and the potential benefit from it. It is kind of like a business plan that they will then submit to their manager, who will then take the decision. The experience of a trader on the field is an important factor regarding the ability to see when it is worth it or not. That is why, under special circumstances, the less experienced trader will always rely on his superior.

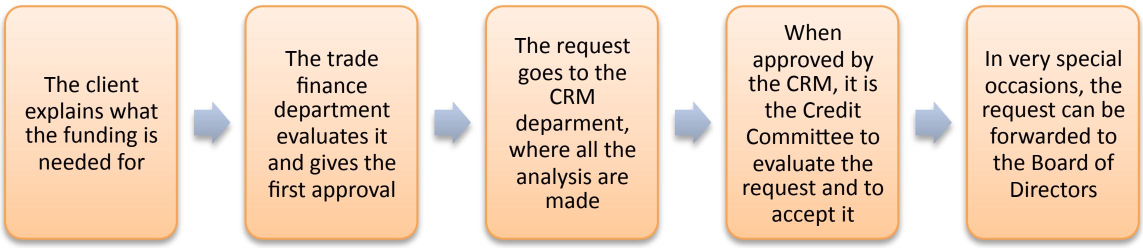
Another factor regarding decision-making, is the size of the company. I had the chance to interview traders from huge multinational trading companies who explained to me that the decision-making process under special circumstances is very controlled and must pass through various steps. Large trading companies often have stricter rules with immediate penalties. In the smaller companies the traders just talk with their colleagues. For instance, the trader just needs to talk to his trading group and in order to do the transaction, the majority of its colleagues must give their approval.

<u>Bankers</u>

In trade finance, the client's requests are taken very seriously.

Here is a chart illustrating the approbation process.

CHART 1: APPROBATION PROCESS IN TRADE FINANCE



At the end of the day, it is somehow understandable that a bank must go through all that process for each trade finance transaction. They are the ones who take the risk of not being paid or delivered when it related to prepaying producers.

Documentation is a very important condition for a bank to take decision because it is what gives them security for the transaction. For instance, if the counterparty's bank provides a confirmed letter of credit, the bank can ask for payment upon presentation of a bill of lading. You can find in appendix a chart illustrating the L/C process. Documentation, especially titles documents, is also what gives them the right to sell the goods in case the trader's buyer defaults.

5. Conclusion

5.1 Problematic

For reminding, the problematic was to define whether or not country risk is the “raison d’être” of commodity trading companies. Thanks to the interviews, I have a better understanding on how country risk is managed.

I understood that country risk has nevertheless some advantages such as creating opportunities. Without country risk, every market would be easily traded and small benefits would be generated from international trade.

I also understood that the oil market is very special and different from any other markets. Indeed, oil is so vital to many industries and so important for the preservation of industrial civilization as it is nowadays, that it is a crucial concern for many nations. No other commodity has evolved this importance in the world economy. In 2008, out of the world’s top 20 private companies, twelve were oil companies or car manufacturers. Many oil-exporting countries are so dependant on it because of the lack of diversification in their generation of income. It is such an essential raw material, that it is sold in enormous quantities worldwide since 1928. When we talk about oil, we talk about billions of dollars of trade and millions of barrels imported and exported everyday.

It is so strategic that no one dares misbehave when oil is concerned. It is probably the less defaulted commodity. However, people in the oil market go crazy when the countries go wrong i.e. when there is wars or terrorism and the production is disrupted. It is indeed a big deal.

In order to answer the problematic, I must first define what is the role of trading companies. Initially, and every trader would tell you, commodity trading companies exist in order to get the commodities from where it is produced to where it is needed. They basically are the link between the producer and the consumer.

Therefore, my hypothesis is that if there was not country risk, the producers could sell directly to the consumers and the traders would no longer be needed. It is thanks to their expertise in transport, logistics, financial instruments and **risk management** that they are useful.

5.2 Personal conclusion

The idea of this topic for my bachelor thesis came along the first semester of my commodity trading class. We were asked to do newsletters about specific commodities and my group and I had to write about crude oil. It is when I discovered the whole dimension of crude oil, which I did not consider at that time. I realize its importance and reactions towards events. I found it fascinating how the oil market increased or decreased according to circumstances. My first though was, knowing where the oil is produced and what happens in these countries, why are the margins so small for a product so risky. “The higher the risk, the higher the return”.

The methodology used for this research was suggested by Prof. Emmanuel Fragnière. I immediately understood that my biggest challenge would be to find and contact the potential interviewees. Quite worried at first, I started sending emails and making phone calls to my restricted network. I was surprise with the availability of the traders and bankers and their willingness to meet me for the interviews. I am grateful for this suggestion because I had the chance to meet very interesting and experienced people.

To sum up, this work has been very rewarding and helped me to better understand the business of commodity trading which I find even more fascinating now.

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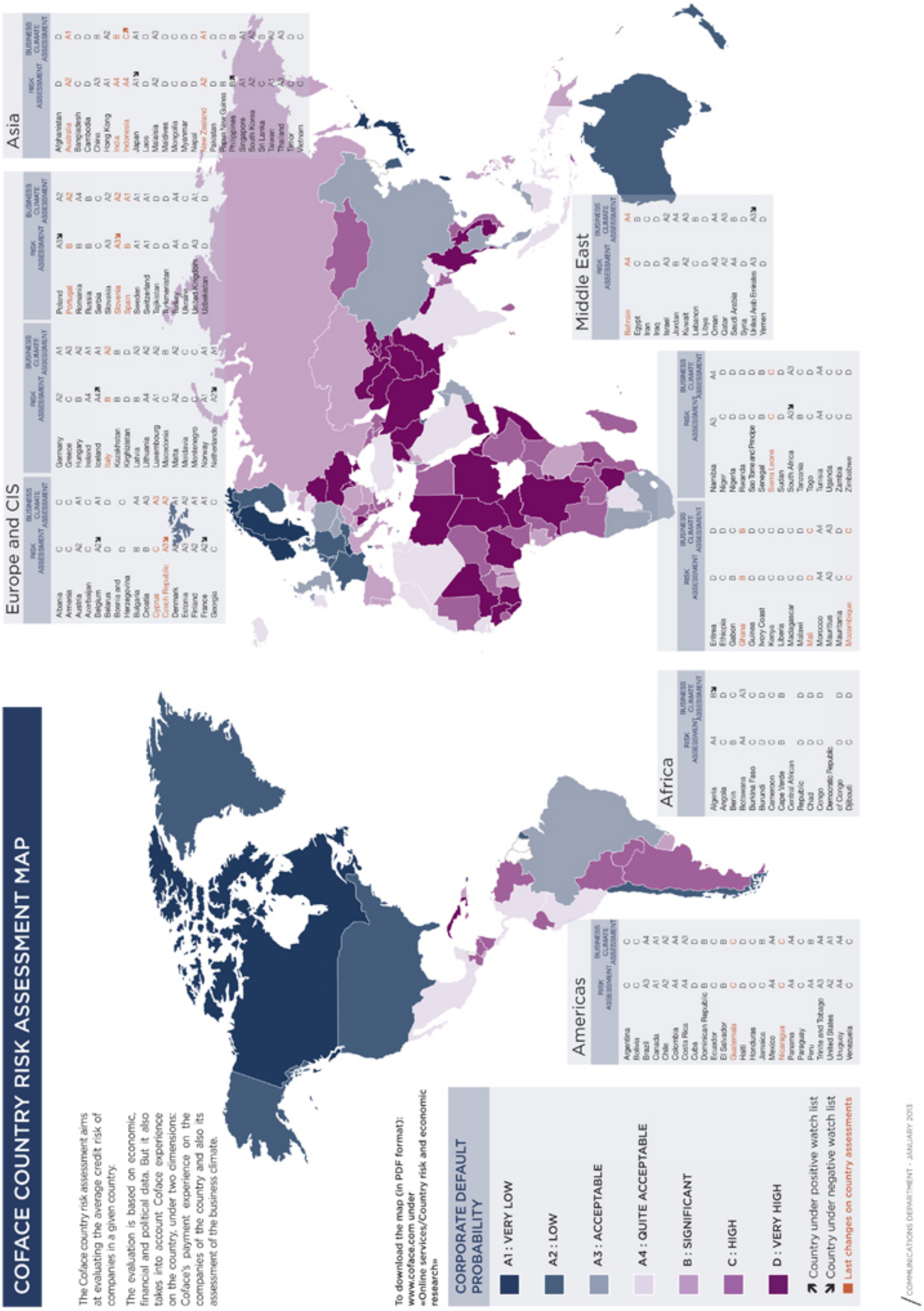
Appendix 1

COFACE Country risk assessment map



Appendix 2

Definitions des évaluations Pays

A1	Les perspectives macroéconomiques et financières sont très favorables. Le contexte politique est stable. L'environnement des affaires est de grande qualité. Ce cadre influence positivement le comportement de paiement des entreprises. La probabilité moyenne de défaut est très faible.
A2	Les perspectives macroéconomiques et financières sont favorables. Le contexte politique est généralement stable. L'environnement des affaires est globalement de qualité. La probabilité moyenne de défaut des entreprises est peu élevée.
A3	Les perspectives macroéconomiques et financières sont moins favorables et/ou volatiles. Le contexte politique reste stable. L'environnement des affaires peut présenter des lacunes. La probabilité moyenne de défaut des entreprises se situe à un niveau satisfaisant.
A4	Les perspectives économiques et financières peuvent être marquées par quelques fragilités. Le contexte politique peut connaître des tensions. L'environnement des affaires peut présenter des lacunes significatives. La probabilité moyenne de défaut des entreprises se situe à un niveau convenable.
B	Les perspectives économiques et financières présentent des incertitudes. Le contexte politique peut connaître de fortes tensions. L'environnement des affaires peut présenter d'importantes lacunes. La probabilité moyenne de défaut des entreprises se situe à un niveau assez élevé.
C	Les perspectives économiques et financières sont très incertaines. Le contexte politique peut être instable. L'environnement des affaires comportent d'importantes lacunes. La probabilité moyenne de défaut des entreprises est élevée.
D	Les perspectives économiques et financières sont très incertaines. Le contexte politique est très instable. L'environnement institutionnel et celui des affaires est très difficile. La probabilité moyenne de défaut des entreprises est très élevée.

Source: COFACE

Appendix 3

Transcripts of interviews

Interviews with the five traders

Trader A.M.

1. How important for you is country risk regarding commodity trading?

Very important because it can be one reason for the banks not to finance your transactions and you don't usually pay with the company money so you loose the business. For instance banks don't do open account for Israel so it's difficult to do business in this country.

Country risk is also important to take into account because of insurances issues.

2. How do you inform yourself about the country risk of a country?

By being on the field. But this takes time (approximately two years to open a branch in a new country). Communication is very important, always talking to people to try to be the first ones to get information.

3. If the country risk is considered too large, what do you do?

A part from not dealing with this country you can't do much. Some people pay bribes to be closer to the government but it is not our policy. We currently have one case in Egypt. Some of our crude is refined there and because of the change of regime, they don't allow us to get our crude back and we have for approximately 100'000'000 of lost crude. For now we're still waiting, negotiating and trying to find compromises.

4. How much you think the percentage of loss due to country risk?

I don't know exactly but I would say that only 1% of our transactions occurred to have some complications. Which is a sense is good because it encourages us to take more precautions for the following ones.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

The story of our crude trapped in the Egyptian refinery.

6. Do you use evaluation of country risk models? Which ones? How?

No, because you don't need them. You use your network to be informed.

7. Can you measure how useful the models were in taking decisions?

Not useful

8. Who takes the decisions?

Usually the manager depending on the transaction. In our branch, we are three people trading energy products and at least two of us must agree in order to do the transaction.

Trader D.W.

1. How important for you is country risk regarding commodity trading?

Very important because political events influence the price. And even for other markets not necessarily energy products, it is important because a lot of products are linked directly or indirectly with crude for example corn because of its use in ethanol.

2. How do you inform yourself about the country risk of a country?

Watching the news, talking to people and the best way is definitely to have someone on the ground.

3. If the country risk is considered too large, what do you do?

We don't do usually, because it is very difficult to make money out of unpredicted political situations.

4. How much you think the percentage of loss due to country risk?

Don't know.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

Those events influence a lot the commodities prices

6. Do you use evaluation of country risk models? Which ones? How?

No we don't use them.

7. Can you measure how useful the models were in taking decisions?

Not useful

8. Who takes the decisions?

In our company, every trader has a risk level (VAR) and it's there choice to allocate the risk in the transactions they want.

Trader J.L.

1. How important for you is country risk regarding commodity trading?

Extremely important because it can change everything. Imagine there is a civil war in Singapour, what should I do with my cargoes over there? I need to plan another itinerary and it might delay the journey and our client won't be happy, plus the price is going to skyrocket. It is definitely a risk to take into consideration.

2. How do you inform yourself about the country risk of a country?

Specialized newspapers (FT, Bloomberg, etc.)

Internal emails from our local branches

3. If the country risk is considered too large, what do you do?

Rely on experienced people. For instance, trying to found out who was the last one to deal with this company and ask for his experience how did it go.

Look for the maximum of possible information by talking to suppliers, local agents, etc. and then talk to my manager if we can do the transaction with a maximum of security and insurances.

4. How much you think the percentage of loss due to country risk?

I can't tell because I don't know. But our company is very concervative, when it is too risky we don't do business, we have a reputation to maintain.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

The biggest impact was the rise of the prices. In this situation our clients are more able to negotiate and the margins are being reduced.

6. Do you use evaluation of country risk models? Which ones? How?

Our risk management department probably uses them but they also do their own analysis. The traders receive internal emails to be informed.

7. Can you measure how useful the models were in taking decisions?

Everyday we receive the reports and it is part of our job to read them. But still those reports are only working tools and usually we are already aware of the information because we talk to our local people.

8. Who takes the decisions?

It is the choice of the Top Management if we do business with a particular country, region, or company in case of difficult situations. Otherwise, it's the trader and its clients that decide in a normal situation.

Trader R.P.

1. How important for you is country risk regarding commodity trading?

It is very important, I believe country risk has created the traders and trading companies.

The biggest risk related to country risk is when there is a change in regime (Kadhafi example)

2. How do you inform yourself about the country risk of a country?

Communication is the key. Traders are constantly on the phone talking to their clients, the producers, etc. In addition, physical traders are going on the field, visiting the plants and their clients. The only way to know the market is to talk to people (banks, suppliers, etc.)

3. If the country risk is considered too large, what do you do?

Rely on experienced people!

4. How much you think the percentage of loss due to country risk?

Statistics show a very small percentage of loss due to country risk. Although there are potential losses, the good question is how much can you recover from them. The solution is usually to extend the payments deadlines so the company continues to perform.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

There have been many stories especially in Libya. For example Vitol was involved in transactions at the time when Kadhafi died and the country was in a change of regime. The situation was very risky and Vitol took the risk, luckily for them they managed to be paid with frozen Libyan founds. Was it already predicted that they could do that or did they gamble it? I don't know…

6. Do you use evaluation of country risk models? Which ones? How?

No, because models can never go down to the contractual level.

But I believe that banks do.

7. Can you measure how useful the models were in taking decisions?

The models only tell you the economic macro factors, therefore it doesn't help you to know if individual transactions worth it. The only way to answer this question is to go on the field and to have a relationship with your counterparty. So not very useful.

8. Who takes the decisions?

Depends on the trader and the company. The top pyramid can take the decisions by talking to the banks because they need to be financed anyway.

Trader J.T.

1. How important for you is country risk regarding commodity trading?

It's very important as well as default and counter party risk, which can be part of country risk. Because crude oil is so volatile and its price change constantly, people can be tempted to not perform when the price changes against their favour.

2. How do you inform yourself about the country risk of a country?

What is special with crude oil is that the market is so liquid and transparent that everyone knows everything. Simply by reading the specialized newspapers and by always having your colleagues, who are on the field, on the phone.

3. If the country risk is considered too large, what do you do?

We try to obtain a prepayment from the counter party, which is quite difficult and rare. Very often when a transaction is very risky, the returns are also high. People still deal with risky countries because it's worth it!

One of the main issues with dealing with countries in the Middle East is that very often you deal with the governments and if they default you cannot sue them, so the only solution is to try to do better next time to make up for the loss.

Anyway, to take a decision you should always do the ratio between what you loose and what you win, if it's not advantageous anymore you stop.

4. How much you think the percentage of loss due to country risk?

No idea. But I know that it had happened that some bills where unpaid due to country risk especially because of a change in government in Middle East countries.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

I was working with grain products at that time, therefore I am not really aware of what happened for my colleagues dealing with energy products.

6. Do you use evaluation of country risk models? Which ones? How?

No we don't use them.

I'm afraid that does models can be sometimes irrelevant. For instance, you pay to have access to them and turns out all the information is either useless or you could have found it yourself by googling it.

Usually, big companies don't need to rely on models because they have their own analysts and country risk analyst department.

7. Can you measure how useful the models were in taking decisions?

Difficult to quantify but I believe it's not the models that can help you in bad situations, but only experience. For instance, you absolutely need to buy crude from Guiné Bissaou, something bad happens, you are not going to rely on models, what you have to do is to pay them off and next time you try to anticipate. That is why experience prevails everything.

8. Who takes the decisions?

First, the trader has to do a business plan and then it is up to the operations council to decide if they do the transaction or not based on their experience and the business plan.

Interviews with the five bankers

Banker D.H.

1. How important for you is country risk regarding commodity trading?

Country risk is very important. Today Country risk must be qualified in two categories: pure country risk and compliance risk.

Traders buy where they can as long as prices are interesting. They do not care too much about the country risk, they pass the baby to the bank and the bank is in charge of managing country risk.

Because of Country risk, our bank no longer trades with Syria and for example some problems in Sudan makes it difficult to trade because of the differentials between north and south

2. How do you inform yourself about the country risk of a country?

I read specialized media such as FT, Bloomberg, etc. I also read publications by Platts, Marketwire, Argus, etc. But the most effective way to keep up to date is to talk to your local people if the bank as a branch in the country concerned.

However, I would be careful with direct contacts with people from governments because it is not always accurate since they tell what is best on their behalf. I would rather talk to maritme people or inspection companies than talking to someone in the government. They should be fairer.

3. If the country risk is considered too large, what do you do?

Credit lines are assigned by the bank for each country, meaning that the bank decides how much maximum risk they are willing to take for each country. This is called Country Envelope. If it is too risky and the Envelope for this country has already been enough used, we ask our client to take an insurance.

The bank also contracts insurances but we have to do it discretely and informally because it could encourage the client to default.

4. How much you think the percentage of loss due to country risk?

I can't tell you a number. What we do is a back testing for each transaction, meaning that if a transaction goes wrong we watch it carefully and the transaction goes into a "watch list". Usually when something bad happens the only solution is to extend the repayment deadlines. But since Crude Oil is so important for a country especially for a developing one, people prioritized their expenses and the company ends up by paying even with some delays, otherwise they know that we won't be dealing with them anymore.

5. What was the impact of Middle east conflicts such as Gulf wars, Arab Spring, etc. for you as a banker?

Before that, there was less pre-financing therefore less risk. Prepayments are fairly recent. Our bank is not a risk taker. When those events occurred, we were still doing transactions because anyway everyone knows that crude oil is the last thing to be impacted because any government will do its utmost to run its oil industry.

We had some issues in Egypt because they stopped the Sumed pipeline but we found a way to get around it and the crude could finally be delivered.

Regarding the current embargo on Iran, our bank absolutely complies with the sanctions because compliance and reputation risk is our top priorities.

6. Do you use evaluation of country risk models? Which ones? How?

Our branch in Geneva does not do evaluation of country risks but our headquarter does. I don't know exactly which ones they use if they use any. But here in Geneva we receive everyday the reports our analysts made and we carefully read them and take into consideration.

7. Can you measure how useful the models were in taking decisions?

I don't think they are much useful because there is always a lag between the analysis and its publication. Therefore, it might be accurate enough by the time we receive and read them

8. Who takes the decisions?

The transactions go to the Credit committee and the chief group must consult its supervisors, he can't take the decision by himself. We have a whole process to follow and it is the Credit committee to decide after presentation of the transaction.

Banker P.Z.

1. How important for you is country risk regarding commodity trading?

Very important because obviously if the situation of the country favorable, one take the risk of not being paid by the final consumer. For example, if your clients wants to pay but because of the country situation the bank doesn't give him access to the local currency, we won't be able to pay. Therefore, it is very important to analyze country risk and take it into consideration before accepting a deal.

2. How do you inform yourself about the country risk of a country?

To me it's like commun sens. People should listen and pay attention to what is going on. Our job is in direct link with the reality. To do so, we are constantly in touch with local stakeholders. But in general, when you deal with a country for long time, you automatically notice if the situation is positively or negatively evolving.

3. If the country risk is considered too large, what do you do?

There are three solutions:

- Ask the trader (client) if he did is own country risk analysis. If not, it's not a good sign. It means that the client is not serious and the bank shouldn't go further with him

- If the trader did his own analysis of the risks, the second thing to do his to make sure that the company he's working for has enough equity. In worse case scenario, the bank would ask the client to repay the debt.

- In the case of it is a small client, meaning that it is a small company with very limited equity, the bank will ask for guarantees and will impose conditions such as having a L/C confirmed from an acceptable bank.

4. How much you think the percentage of loss due to country risk?

Every bank defines an envelope for each country in order to fix the maximum amount the bank is willing to take on country risk. So it is very difficult to talk about losses because everything is very controlled.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a banker?

During the Arab Spring, Egypt took a lot of delay in paying the cargo, so the consequences were to restrict the credit lines for financing transaction in Egypt. We manage to be paid after many travels and negotiations.

In general there isn't losses but just payment' delays and this is explained by the fact that oil is so strategic that even if a country has many other bills, the priority is to pay the ones related to oil. The real losses occur when there is debt restructuration as it was the case for Greece. In this situation we talk about deadweight losses.

6. Do you use evaluation of country risk models? Which ones? How?

Non. I don't trust so much those models because in most of the cases we have a better knowledge and understanding on what is going on. I strongly believe it's better to do your own analysis and we have a whole department dedicated to that.

7. Can you measure how useful the models were in taking decisions?

Not useful

8. Who takes the decisions?

Most of the time the trade finance passes the case to the Credit Committee, who's in charge of the approbation.

Banker S.Z.

1. How important for you is country risk regarding commodity trading?

It is important because in one hand it is an opportunity to do better margins but on the other hand it also adds a cost and this cost comes at the moment when the banks finance the transaction and add an additional interest called TCR according to the country risk rating of the country in question. Many traders forget to take into consideration this additional cost and the purchase price is distorted.

2. How do you inform yourself about the country risk of a country?

Reading the press and specialized magazines and publications in order to try to forecast the future events. A trader is always looking for opportunities and more the market is transparent less there are opportunities. So the key is trying to get the information that the others don't have yet and to do so, you have to travel and visit the countries, talk to the people, etc.

3. If the country risk is considered too large, what do you do?

The first questions would be: Is it worth it? Does it goes against my values and ethical perceptions? Wouldn't be better to get the crude from somewhere else and avoid useless costs such as TCR? Etc. After answering these questions and many others I would decide if I go for it or not.

4. How much you think the percentage of loss due to country risk?

Not much because oil is so strategic that people don't play with it and perform as decided.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a trader?

I remember during the Koweit invasion, the situation was disastrous because we didn't have any plan B.

When there is extreme events the first thing to do is to take a broad picture and analyze the situation. Are we short or long? Where are my cargoes? Are they impacted? Etc.

6. Do you use evaluation of country risk models? Which ones? How

No. I believe that these models are rather for investors or hedge funds. Traders and bankers don't need this because they already know about the situations of the interested countries. It is their everyday job to seek for information.

7. Can you measure how useful the models were in taking decisions?

The only thing I could think of how those models could be useful is to read them in order to take advantage of the ignorance of the others and then try to anticipate what the other could read.

8. Who takes the decisions?

I think it depends on the company and their control system. Big companies are more likely to have a strict control system in place.

It also depends on the banker and its position in the company. Obviously an experienced person is more able to take decisions than junior.

Banker S.C.

1. How important for you is country risk regarding commodity trading?

Very important! Every bank has its own department specialized in country risk and this department works closely with the department of trade finance.

The country risk analysis department analyses each country we are doing business with and grades it. We read carefully those reports and take into consideration what the grade for the country in question is, in order to take the decision on should we finance our client or not. Obviously there are other criteria to approve a funding such as the solvability of our clients, etc. but definitely the country risk of the country concerned is a great deal in taking decisions.

2. How do you inform yourself about the country risk of a country?

Generally people working in the trade finance have a considerable background on the commodity as well as an important network. We read a lot of newspapers not only the Swiss and international ones but also the locals from countries we are operating. We are constantly talking to our colleagues that are in charge of analyzing the country risk situations. These people are constantly travelling to visit the local banks and others institutions. They meet a lot of people, which allows them to make their proper judgment of the situations and give us relevant feedbacks, because sometimes just reading the newspapers only gives you a subjective idea and not what the real situation is.

3. If the country risk is considered too large, what do you do?

First of all when a client asks for financing a transaction in a particular country, we check if this country has a rating made by the bank. If not, it means that we don't deal with this country and therefore the request is refused.

If the country is rated, we check what the grade is and what is the limit enforced by the bank. This limit (envelope) is jointly decided by the Risk Management department, the Credit Committee and the Trade Finance department.

What we can do if this limit is too short or already exhausted is to suggest the Credit Committee to adjust it and often the General direction must give its approval. Finally, we also check the solvability of our client. Can he pay us back if something bad happens?

4. How much you think the percentage of loss due to country risk?

In our bank, we had never experienced any loss due to country risk. The transactions have always been performed and paid on time.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a banker?

As I said, we never had any problems even during the Arab Spring, etc. But those events have impacted on our bank policy regarding risks and country risk.

Our bank is more conservative than other ones as long as equities are concerned. We certainly have smaller limits than other banks, which prevent us to lend exorbitant amounts of money. Moreover, since late 90s, the oil market progressively became more structured and nowadays the companies involved in this business are the big ones with a lot of financial capacity.

6. Do you use evaluation of country risk models? Which ones? How?

Our country risk analysis department looks at some publications especially the ones from Standard & Poor's. They compare and what they found out is that the assessments differ from one analysis to the other.

7. Can you measure how useful the models were in taking decisions?

Not so useful because we don't depend on their assessments because we make our own. And we are sure that our analysis are relevant anyway, something that we are not sure for those models that could have been manipulated.

If a model shows different results we are still going to use ours. We acknowledge them just for information.

8. Who takes the decisions?

In a simplified approach, the request if firstly approved by the trade finance department, then it is sent to the country risk management department, where financial, political, geopolitical etc, analysis are made. If they approve it, it goes to the Credit Committee. This last one can end the chain and give its approval but when it is a delicate transaction, the Credit Committee can forward it to the Board of Directors who will be in charge of taking the decision. They vote and the majority wins. They are the ones who take the responsibility.

Banker Y.B.

1. How important for you is country risk regarding commodity trading?

In trade finance, country risk is very important because we must know if the products we are financing are produced or stock in risky countries. We often do prepayments for a product that will be produced in the next 30 days, if the production is located in a risky country we have to ask ourselves how much risk we are ready to take on because if something goes wrong our equity could be impacted.

2. How do you inform yourself about the country risk of a country?

Through the media and newspapers, through the client or our experts. And especially we must be careful with the rumors.

3. If the country risk is considered too large, what do you do?

We check carefully all the details of the transaction and we as for a maximum of securities and we impose to the client very strict conditions.

4. How much you think the percentage of loss due to country risk?

In general the client pays back so so far the bank doesn't have lost much money. For example, once we financed a transaction of corn in Ukraine and when the U.S. imposed a ban on the Ukrainian exports, our client couldn't sell it to its customer. So we ask our client to pay us the money we lent and it is up to the client after to manage to sell his corn maybe to someone in Ukraine in order to recover the money he paid us.

5. What was the impact of Middle East conflicts such as Gulf wars, Arab Spring, etc. for you as a banker?

We didn't face any particular impact because the bank wasn't financing risky transactions or if it was, it certainly was very small amounts. But in such cases for example, the bank doesn't do any prepayments. We only finance the transaction where the cargo is already loaded and out of the risky countries' ports.

6. Do you use evaluation of country risk models? Which ones? How?

Our bank does its own country risk rating system. We sure look at ratings such as S&Ps etc. and if our ratings do not coincide with the standard, we might adjust them.

7. Can you measure how useful the models were in taking decisions?

Not so useful except to adapt our ratings and keep informed.

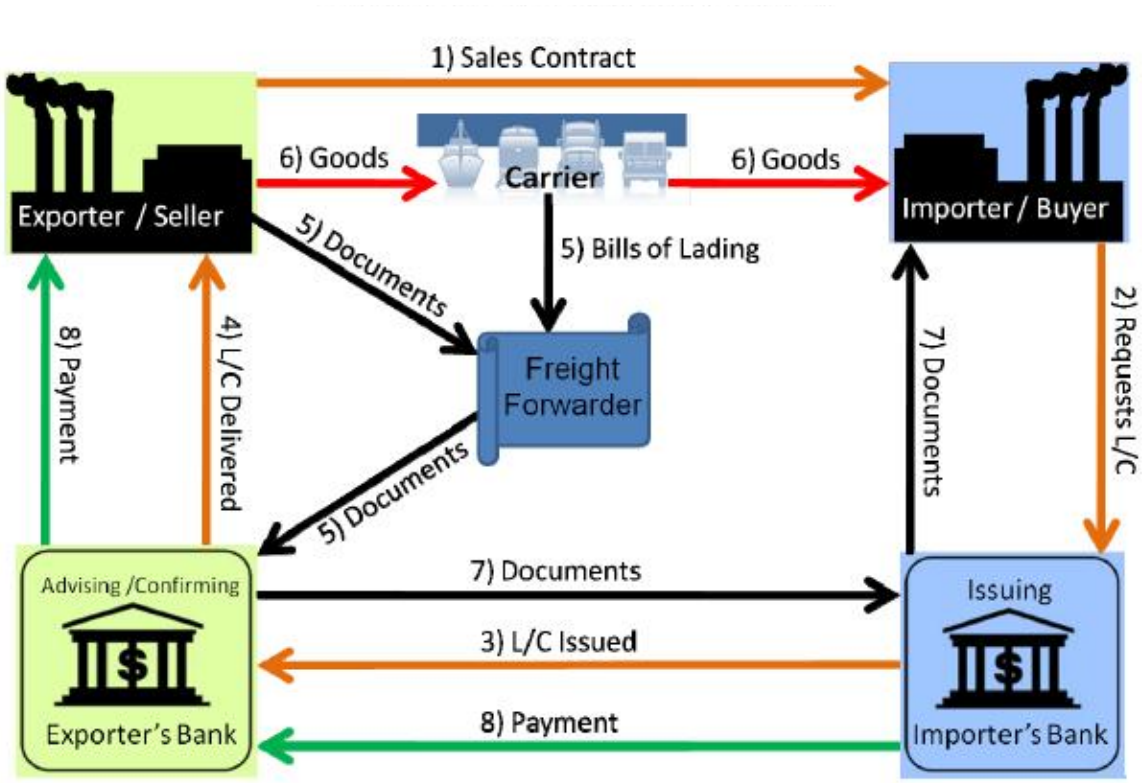
8. Who takes the decisions?

The banker will take position but its manager must validate it. And depending on the transaction, the decision will be tanken higher or lower in the hierarchy, meaning that if it's a complex transaction higher managers or board of directors will take the decision.

Once we had a case of a client asking for funding for a transaction in Ghana, unfortunately, our credit line for this country was to short so my colleague, after evaluating the worthiness of the transaction, asked our credit line managers if the envelope could be increased.

Appendix 4

Letter of Credit Flow Chart



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