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OECD Country Classifications

32nd FELABAN LATAM Conference on Foreign Trade (CLACE) Conference
EPIC HOTEL
270 Biscayne Boulevard Way
Miami, FL 33131
Monday, May 23, 2016

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OECD Country Classifications

The OECD country classifications are designed to capture country risk as distinguished from sovereign risk.

- Sovereign risk captures the probability of the government defaulting on its bonds.
  - This is typically what we are hearing about when we are told a rating agency, such as S&P, Moody's, or Fitch, is said to rate a "country“, for example across the spectrum from AAA, AA, A, BBB, BB, B, etc.

- The OECD country classifications are more similar to another type of rating these agencies also issue, which is often called the "country ceiling" or the "sovereign ceiling".
  - This captures transfer and convertibility risk (aka “T&C risk”)
  - T&C risk is the possibility a government will declare a "payments moratorium", under which a class of issuers, possibly ALL issuers domiciled in the country are barred from making external payments or transfers, and/or converting the local currency into hard currencies

OECD Country Classifications
Two-step Methodology

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The OECD classifies countries through a "two-step methodology":

1. A quantitative assessment based on:
   a. Payment experience (of "Participants to Arrangement on Officially Supported Export Credits");
   b. The financial situation of the country;
   c. The economic situation of the country.

2. A qualitative assessment by country risk experts from OECD members, including political risk.

The dialogue that goes into the second step of analysis is kept confidential with no official reports being made publicly available.

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Country Ceilings and T&C Risk

Discussions in the second step in the OECD's two-step methodology – the qualitative assessment by country risk experts – are confidential.

- However it is reasonable to presume the focus follows well established practices, such as those employed by in-house analysts and rating agencies.

Moody's, for example, considers three questions:

1. *To what extent is the local economy integrated into the world economy?* The implication here is the more commercially and financially integrated a country is, especially involving legally enforceable contracts subject to foreign law, the more difficult it will be to impose a payments moratorium.

2. *Would the government perceive a moratorium as more costly than other policy alternatives* (such as a maxi-devaluation that would dramatically increase the cost of both imported and locally produced goods the county's residents buy)?

3. *Is the government likely to "socialize" the cost of a crisis* - e.g., take steps to sacrifice government finances (possibly through higher taxes) and monetary conditions to protect strategic companies (usually hard-currency earners) from defaulting on creditors? This last point is of interest to those in trade finance, because trade is typically allowed to pierce country rating ceilings based on the expectation that, in a crisis, trade obligations will be allowed to settle even when other transactions are not.

Economic Fundamentals and Political Analysis

Reflecting on years of rating countries, regardless of whether we are thinking in terms of sovereign risk, T&C risk, or other types of general country risk assessments, nearly every analysis considers the economic fundamentals of:

1. Economic growth and inflation;
2. The fiscal balance and public debt (typically as a percent of GDP);
3. The current account and trade balances (typically as a percent of GDP);
4. External debt (typically as a percent of GDP) and FX reserves (typically in US$).

Political analysis is naturally more qualitative than the economic and financial analyses. Two categories I focus on include:

1. First, what is the "governability" in the country, that is, how able is the current government to achieve its objectives?
2. Second, what is the business and investment orientation of the current government, including how technically competent is the economic team and regulators?

Also important is the efficacy of the judicial system (and ability to enforce a contract and rely on property rights); and corruption, especially at the official level.

Shortfalls in the OECD Classifications

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My critique of the OECD classifications is three-fold:

1. Because of the focus on the currency they do not classify the high-income OECD and Euro-zone countries.
    - There is a logic that the hard currencies have no recent history of becoming inconvertible but in March 2012 Greece had the largest sovereign default in history (haircuts of $130bn) then in July 2015 imposed limits on bank withdrawals and prohibited transfer of capital and cash outside Greece. Yet the country was not classified because it is on the euro (these countries went from 0 to no classification for the highly developed countries in January 2013)

2. Timeliness can be compromised
    - Partly because of a lack of granularity, meaning they may not move despite important deterioration in the risk profile (they have eight classifications running zero through seven)
    - Also their experts meet only several times a year, which cannot possibly be as nimble as a permanent staff, and this comes into play when it matters most, which is the fast-moving dynamics of an unfolding crisis

3. In my opinion, sovereign risk and T&C risk are too narrow.
    - Consider Brazil. Despite their issues they are not considered in immediate danger of a sovereign default and the country remains very much externally liquid. Yet no one can argue the risk of doing business there has not elevated in the past five years.

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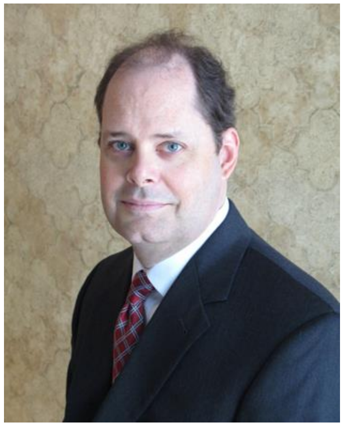
Philip Stafford is a Director in Country Risk Analytics for the Americas at Wells Fargo Bank. He joined Wachovia in November 2005, which has since merged with Wells Fargo. Before that he had a similar role at Bank of America, covering Europe, the Middle East and Africa, so he is beginning his eighteenth year in country risk management. He completed a Bachelor's Degree in Economics at the University of North Carolina at Charlotte in 1990 and a Master's Degree in Economics at the University of Washington in Seattle, Washington in 1993. He served three years as President and is currently the Chairman of the Advisory Board of the Charlotte Economics Club, the Charlotte chapter of the National Association for Business Economics (NABE).



He is responsible for all country risk coverage of the Americas, including:

- assigning country risk ratings for thirty-one countries in the Americas where Wells Fargo has limits;
- participating in setting country limits to regulate the size, product, tenor profile and risk mitigation of the bank's foreign exposures;
- monitoring country exposure to ensure it remains within limits and the proper risk profile;
- providing analysis to support external risk mitigation, credit underwriting, and specific transactions;
- addressing external investors about country risk in Latin America to build relationships with partners to participate in large syndicated or securitized transactions or to possibly purchase assets from Wells Fargo, allowing the bank to manage its concentration to large clients or particular countries;
- traveling to countries for on-site assessment of economic, business, financial, and political conditions; and
- participating as a member of the Wells Fargo Latin America Operating Committee and the Latin America Compliance and Operational Risk Council.

He has visited the following countries in a professional capacity: Argentina, Austria, Barbados, Canada, Chile, Colombia, Costa Rica, Czech Republic, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Israel, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Poland, Slovak Republic, Taiwan, Trinidad and Tobago, Turkey, United Arab Emirates; United Kingdom, Uruguay, Venezuela.

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