Sovereign risk premium - an important factor in facilitating the comparability of financing transactions 2/15/25


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Intra-group financing transactions are a way for corporate groups to promote efficient capital allocation, stimulate development and provide more flexibility and control over financial resources than external financing. However, as with all other intra-group business transactions, transfer pricing risks should not be forgotten in financing transactions.

This article discusses an important but sometimes overlooked comparability factor to consider in cross-border financing transactions with related parties: the sovereign risk premium.

Sovereign risk premium

The sovereign risk premium is the additional compensation that lenders demand when they grant loans to companies in countries with potentially different economic, political or financial conditions. The sovereign risk reflects the risk that the state will default on its debt.

In practice, sovereign risk adjustments are made to reflect the risk in financial transactions arising from different economic, political and other circumstances between several countries. In some cases, sovereign ratings established by specialised agencies (such as S&P) can serve as a good starting point for sovereign risk adjustments.

From a transfer pricing perspective, the application of the sovereign risk premium helps to ensure that the interest rates applied to financing transactions reflect the economic climate and provide more accurate comparability with other comparable market transactions, thereby ensuring compliance with the market pricing principle.

Sometimes the application of a risk premium can act as a lifeline. For example, according to basic economic principles, borrowers with high credit ratings are subject to lower interest rates, but comparable interest rates selected in specialised databases often turn out to be inappropriately low and the interest rate would be much higher if the financing were obtained from an unrelated financial institution.

Therefore, in cross-border intra-group loans, the sovereign risk premium can play a crucial role and apply an interest rate to the transaction that more accurately reflects the market situation and the transaction terms agreed by unrelated parties, such as the bank.

Example

The application of sovereign risk to financing transactions shall include the following steps:

Step 1: Setting a basic interest rate using specialised databases or internal data on comparable transactions.

Step 2: Collection of information on sovereign risk premiums.

Step 3: The application of the sovereign risk premium to the selected interest rates according to the following formula:

Sovereign risk-adjusted interest rate = unadjusted interest rate + (Risk premium of sovereign risk premiums of the residence country of the borrower in the controlled transaction – Sovereign risk premium of the residence country of the borrower in an uncontrolled transaction)

Step 4: Determination of the market range for interest rates.

Let us look at a theoretical example of believability. In 2024, the Latvian company granted a loan to a related Lithuanian company. For the purposes of setting a market price interest rate, the lender selected the reference data in a specialised database where information was obtained on three comparable loans granted to Austrian, German and Belgian companies. Without carrying out an in-depth analysis, the Latvian company calculated the market interval and applied an interest rate of 3.3% to the loan, which corresponds to the median market interval.

If an entity had carried out an in-depth analysis to obtain more comparable data and applied sovereign risk premiums according to the above formula, the results would have been significantly different:

	Step 1	Step 2	Step 3	
Comparable transaction	Unadjusted interest rate	Risk premium	Difference in risk premiums[1]	Adjusted interest rate
No.1 (Austria)	2.10%	0.49%	0.54%	2.64%
No. 2 (Germany)	3.34%	0.00%	1.03%	4.37%
No. 3 (Belgium)	4.12%	0.73%	0.30%	4.42%
Lithuania	-	1.03%		

Step 4

	Unadjusted interest rate interval	Range of interest rates adjusted for sovereign risk
Minimum value	2.10%	2.64%
Lower quartile	2.72%	3.51%
Median	3.34%	4.37%
Top Quartile	3.73%	4.39%
Maximum value	4.12%	4.42%

The obtained result is two different market price intervals that illustrate the transfer pricing risk. The interest rate applied by a Latvian company to the bond issued to a related foreign company is not within the interquartile range. In such a case, the tax office would have the right to make a transfer pricing adjustment, to increase the corporate income tax base and also to calculate the fine.
It is important to emphasise that this approach applies when the data is selected for individual comparable transactions, i.e. through specialised databases or internal comparables. If information on interest rates is obtained in aggregated form, e.g. using data published by the Bank of Latvia or the European Central Bank, it is not possible to apply the sovereign risk premium as the data obtained is not accurate and therefore misleading.

If you need advice on the aspects mentioned in this article, please contact the PwC Latvija transfer pricing team.

[1] Difference in risk premiums = sovereign risk premium of Latvia - risk premium of the country of residence of the borrower of a

comparable transaction