CHAPTER II

EXPORT CREDIT AND EXPORT FINANCE

Introduction1. The provision of export credit insurance is a very effective way of stimulating exports. it is, however, a separate activity from the provision and funding of export finance, although they can be closely linked.

Background

2. Each year the 46 Members/Observers of the Berne Union the International Association of Export Credit and Investment Insurers cover about $420 billion of exports and about $15 billion of foreign exports, 90% is in respect of goods and services sold on cash or short term credit (i.e. up to 180 days) and about 75% is in respect of exports sold to buyers in OECD countries.

3. It is clear from these figures that it is quite wrong to see export credit as involved only (or even mainly) with:-

(a) Medium and Long term credit for capital goods or manufactured goods

(b) Exports to Developing Countries or non-OECD countries

4. Indeed a key reason for having an Export Credit Agency is to encourage and support exports sold on cash or short credit to OECD countries.

Bad Reasons for Having an Export Credit Agency

5. As the rest of this paper shows, there are many good reasons for establishing an Export Credit Agency.

6. However, there are also a numbers of <u>bad</u> reasons. For example:-

(a) It is not helpful to either exporters/banks or the exporting countries themselves to stimulate, encourage or support exports to countries or buyers who will <u>not</u> pay for them.

(b) It is expensive and wasteful to use medium and long term export credit as a way of <u>subsidising</u> interest rates paid by overseas buyers. The beneficiary of the subsidy is of course the overseas buyer. OECD countries have learned the hard way how expensive and distorting and wasteful of public expenditure these blanket subsidies can be; this is why they are being phased out. They are, of course, much easier to introduce than to withdraw.

(c) It is not necessary to establish an ECA in order to provide bank finance to exporters in the manufacturing or preshipment stage; especially if such finance is provided at subsidised rates of interest. In any case, the provision of this kind of "overdraft" finance is a normal commercial bank function and it gets banks into bad habits if the Government involves itself in these day-to-day market / commercial decisions, as well as being very expensive for Governments who normally end up with all the bad debts.

<u>Political Risks and Commercial Risks</u>

7. There are many risks involved in exporting but the two categories most usually covered by export credit are political risks and commercial risks.

(a) <u>Political Risks</u>

The main kinds of risk are those relating to the actions of Governments of buying countries in preventing payments being made for imports, e.g. problems with transferring foreign currency, the imposition of import controls, war/civil war, defaults by Government or Public Sector buyers/guarantors.

(b) <u>Commercial Risks</u>

The main risks are the insolvency of the buyer, default or repudiation/refusal to accept goods/services.

8. It is a very common - and very expensive - mistake to believe that it is only political risks which give rise to problems and losses and thus that exports to OECD countries are "safe". Most of the Members of the Berne Union pay substantial commercial risk claims every year - and especially during recessions - on the United States and EC countries. This simply reflects the large number of private companies who every year become insolvent or default on payments.

Protection Against Risks

9. The traditional and still the major reason for having an E.C.A. is first to provide exporters with the confidence to export (i.e. confidence that they will be paid) and second to protect them against losses. For new or smaller companies, one bad debt can be significant enough to cause them to become insolvent.

Access to Bank Finance

10. Export Credit Insurance provides a very useful security for exporters to use with their banks to obtain bank/overdraft finance. In addition, to provide even greater security to a bank, the insurance cover can be given direct to the financing bank by the E.C.A. This is a very important point in most countries but especially in countries where the banking system is undergoing significant change or where new banks may be unfamiliar with the mechanisms and techniques of foreign trade financing.

Information

11. Information on overseas buyers and countries is expensive to obtain and keep up to date. It is not, therefore, cost effective for all exporters (or banks) to try to do this for-themselves. Worse still, is for them to sell (or finance) "blind" with no information. An E.C.A. thus offers the possibility of a single/central body collecting and maintaining

information (and exchanging it with similar bodies overseas) and thus obtaining economies of scale to the potential benefit of all those in the country involved with foreign trade.

Expertise

12. Like information, expertise in technic al aspects of foreign trade and trade financing is scarce and expensive. An E.C.A. provides a focal point within which to concentrate these scarce resources (and a cost effective way of obtaining and developing them).

13. In other words, an E.C.A. offers more to exporters and banks than insurance only.

The Importance of Marketing

14. The need for export credit insurance and the many varied benefits it can bring (see paragraphs 9-13 above) are not always obvious to companies, banks and administrators, especially where an economy has been operated on a "State Trading" basis, i.e. effectively where the Government made all the key decisions and took all the risks.

15. Thus there is a vital need:-

(a) for an E.C.A. to develop its products with particular reference to the situation in its own country (and not simply transfer/import products and facilities offered by E.C.A.s in other countries).

(b) to give great attention to and emphasis on active and professional marketing to both companies and banks. In other words, it is no use simply waiting for customers to come to see the E.C.A.. The E.C.A. must get out into the business and banking community and vigorously market its products and services.

Political Risks

16. It is unusual for political risks on buyers and countries outside the OECD to be underwritten either on its own account by a private company or E.C.A. or for the Private Reinsurance market to be willing to reinsure such risks.

17. It remains diificult to reinsure medium and long term political ' risks (including risks on Government / Public Buyers) in the Private Reinsurance Market.

18. Thus, for all those Members of the Berne Union who provide Medium and Long term insurance cover, this business is either reinsured by the Government or written on a "National Interest" basis on the account of the Government. Some short term business may also, in specific circumstances, be handled in this way.

Decisions on Political Risks

19. Decisions on political risks (especially on Medium and Long Term cover) are thus usually taken by the Government. It would be a normal arrangement in most countries for political risks on buying countries or on individual cases to be considered by a Government Committee of some sort. Such a Committee would either take the decision or make Recommendations to the Ministry or Ministers who will take the decision(s).

20. In many countries, the Chairman of such a Committee will often come from the Ministry of Finance or Treasury.

21. Amongst the Government Ministries or Departments or Institutions which would usually be represented at a very senior level on such a Committee would be the following:-

(a) Ministry of Finance or Treasury
(b) Ministry of Trade or Foreign Trade
(c) Ministry of Foreign Affairs
(d) Ministry of Foreign Economic Relations
(e) Ministry of Foreign or External Affairs
(f) Ministry of Industry or Commerce
(g) Ministry of Agriculture
(h) Central Bank

22. The decisions taken by such a Committee would either set the limit on business which can be insured on a particular market (e.g. exposure on, say, New Zealand can be underwritten of up to $25 M on short credit terms and up to $50 M on a medium and long

credit terms) or to approve an individual case (e.g. exposure of $15 M can be underwritten on a project to supply engines to the Electricity Board in Turkey). Often such Committees will also approve the premium rates which will be charged for such business/cases.

23. It is often helpful for the Secretariat for the Committee to be provided by the E.C.A. and for recommendations on countries or cases to be made to the Committee by the E.C.A.

Accounting

24. It can be helpful when underwriting such business for two things to happen:-

(a) First, from the premium paid by the exporter for the cover, a fee for the administration of the cover should be deducted and retained by the Export Credit Agency to meet its costs.

(b) Second, for the balance of the premium on such cases to be retained in a special foreign currency account and not paid into general Government revenues. This special account can then be used to finance or pay any claims on such business, which may be submitted in due course by exporters. Thus only if there is not sufficient funds in the account to pay claims would the Government be asked for funds.

Export Finance

25. The points above relate to export credit insurance. However, in many countries there can be problems in funding or financing export credit. They can arise in two main ways.

Pre-Shipment Finance

In some countries, it can be difficult for the commercial banks to provide finance to exporters to enable them to carry out export contracts. In OECD countries, such finance normally comes from an exporter's working capital or from his overdraft from a commercial bank.

However, in other countries, the commercial banks may not be either liquid enough to provide working capital on the necessary scale or they may be cautious about lending on the scale required or may require special security from exporters for such lending.

In such cases, the exporter can sometimes be helped to obtain the necessary working capital for pre-shipment finance if either the insurance from the E.C.A. is assigned to the bank or if the E.C.A. can give some kind of insurance direct to the banks.

29. ECA's need to be cautious about underwriting the exporter (as opposed to the overseas buyer) as there can be problems in sharing security etc. with the banks. However, in some countries, special schemes exist under which the E.C.A. gives cover to the banks who provide working capital/preshipment finance to the exporters (e.g. in Indonesia and Mexico).

Medium and Long Term Finance

It will sometimes be the case that the commercial banks are unable or unwilling to fund medium or long term credit. For example, if an exporter sells on 5 year credit to a buyer overseas, he (the exporter) will normally expect to be paid by his bank by delivery and then the bank waits to be repaid by the overseas buyer/borrower over the 5 years. Repayments of principal and payments of interest will normally be made at six monthly intervals during the credit period. The repayment risks (both political and commercial) will normally be covered by the insurance from the E.C.A. but this still leaves the financing bank with the funding problem. In many countries, this is a problem, which the commercial banks cannot solve, i.e. they are unable or unwilling to raise either from domestic or international sources to the 5 year deposits to "match fund" the credit extended to the overseas borrower/buyer.

-In some countries, this problem/difficulty has been approached by the Export Credit Agency giving guarantees direct to the banks but, in other countries, this has not solved the underlying funding problems and so the Export Credit Agency or some other Government institution have been involved in funding.

The funding, in some countries has been taken over by Eximbanks. There are two main kinds of organisation:-

(a) Direct Lenders

There are institutions who lend direct to overseas borrowers or buyers (e.g. as in the USA and Canada). The advantage of this arrangement is that it is direct and often raises and disperses funds in the lowest cost way. The main disadvantage is that it prevents the commercial banks from developing the ability to borrow and lend for medium/long term credit and can also inhibit the development by the commercial banks of other export and trade finance skills.

(b) Refinancing

There are institutions who raise funds but do not lend direct to borrowers or buyers but refinance or fund facilities extended by the commercial banks (e.g. as in Austria).

33. There is no single best way of organising these institutions and so there are various kinds of banks. For example:-

(a) Institutions such as those in the United States (similarly in Australia, Canada and Turkey) both provide long term loans direct to overseas borrowers and also provide associated and, where necessary, free standing export credit insurance.

(b) Institutions such as those in Sweden, India and Korea operate <u>separately</u>. In other words, the funding and finance is provided for long and medium term exports direct to overseas borrowers/buyers but the associated (or free standing) export credit insurance is provided by a separate institution. It is possible for the export credit institution <u>to</u> provide insurance to the export \ import bank.

(c) In Japan the export credit institution (EID/MITI) and the Exim bank are quite separate and insurance is <u>not</u> provided by the export credit institution 'to the Export Import Bank. In other words, where the Export Import Bank lends on a medium and long term basis, then no insurance will be provided. Conversely, where export credit insurance is provided in respect of medium and long term credit transactions either to exporters or to commercial banks, then the Export Import Bank will not be involved.

(d) In Austria (and soon in the Czech Republic), the institution can raise funds in its own name (or with a Government or Central Bank guarantee) and can then refinance medium and long term credit facilities extended by the commercial banks. Such institutions can either be part of or separate from the E.C.A.'s. However, if they are part of the same institution then it is very important that the activities (or certainly the Accounts) are kept separate.

<u>What is the Best Kind of Organisation?</u>

34. There is no single "model" which is the best one in all circumstances in all countries.

35. The key should be to produce an institution and an arrangement, which are best suited to the particular needs of the country involved. They may need to change as, for example, the activities and expertise of the commercial banks increase.

<u>Main Activities</u>

36. It is helpful to distinguish between three major kinds of activity in a Financing (or Refinancing) Institution. The major ones are:

(a) <u>Raising Funds</u>

This will probably need to be done in the international capital markets and, for many countries, the finance will need to be raised in the name of, or with the guarantee of, the Government. The "cleaner" the guarantee, the lower is likely to be the margin, which has to be paid to the lenders/providers of the finance. It is important that the borrowing or capital raising activity is very closely aligned with the other international borrowing of the Government and/or the Central Bank. Advice on trimming and pricing and terms can be obtained from foreign merchant banks etc.

(b) <u>Holding Funds</u>

Since it is very unlikely that it will be possible to raise the funds at (a) above exactly to match loans for medium and long term export credit on a case-by-case basis, there will be a need to "hold" funds. In other words, there will be mismatches between borrowing and lending/refinancing. Since interest will have to be paid on the borrowings, the funds must be used so as to raise income to pay the interest until such time as the funds are used for the export credit contract. This is a "Treasury Management" function but it requires special skills if losses of various kinds are to be avoided.

(c) Lending/Refinancing

This nature of this activity will depend on whether the institution is to be a direct lender or a provider of refinancing. An important point will of course be whether such funds are to be restricted to export contracts which are insured by the E.C.A.

37. In all of these activities the links with the Central Bank will be of central importance but much will also depend on the skills and experience/expertise and balance sheet strength of the commercial banks. The role of the Bank Supervisors will also be important in terms of how they treat (for balance sheet weightings and risk ratios) the export credit lendings of the commercial banks.

Summary and Conclusions

38. The role of the E.C.A. is very important. This can be concentrated on insurance but this can also involve or have a very close relationship with financing and funding. There is no single or best solution of universal applicability. Systems need to be designed with particular reference to the individual circumstances of the country concerned.

39. What is best for an individual country at a particular time depends on a number of factors. It is a mistake to try simply to "transplant" a model from another country. Many countries have tried this and have failed or have had to make rapid changes to the model they "imported".

40. Thus the essential first stages are:-

To analyse the needs of the individual country and its exporters and banks.

(b) To be aware both of the various arrangements which apply elsewhere and the various kinds of institutions which operate in different countries (some of which are referred to above).

(c) To try to develop the institution(s) for the country from the "models" at (b) which should fit the needs of (a).