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BACKGROUND PAPER ON EXPORT CREDIT INSURANCE

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Background paper on export credit insurance

Introduction

1. Resolution 1, paragraph 7 on Trade and Tourism of the Sixth Summit Conference of East and Central African Heads of State and Government held in Khartoum 26-28 January 1970 decided as follows:

"Export credit insurance

2. ECA should be requested to make a study of the possibilities of setting up an Export Credit Insurance Institution (perhaps several such institutions) because while reasonable credit facilities are often provided by banks there is a reluctance to finance the more risky kinds of export transactions. A carefully devised export credit insurance scheme would fill this gap and better short-term credit facilities."

3. Export credit insurance as a means of promoting exports from developing countries was the subject of a Round Table Conference convened by the Secretary-General in New York from 24-28 March 1969, following a survey of national export credit insurance and export credit financing schemes in developing countries.[1/] This paper is essentially a summary of the salient points that emerged at the Conference and is intended as a background document for the consideration of member countries who would wish to establish export credit insurance institutions.

Historical background

4. Many European countries introduced export credit insurance for short-term transactions, between the two World Wars, with a view to protecting their exporters not only against commercial risks, which loom greater in foreign markets than in the home market, but also against the other risks peculiar to

1/ Report of the Round Table on Export Credit as a means of promoting exports from developing countries - E/4661.

Export Credit and Export Promotion in Developing Countries - E/4481.

Export Credits and Development Financing E/4274 and E/4274/Add.1.

export trade which may interfere with the payment or transfer of the sums due. The scheme was intended to mitigate the effects of the depression by helping to maintain a certain flow of exports at a time when widespread market dislocation, foreign exchange crises and political instability were transforming the conditions under which international trade had previously been financed, making it difficult for suppliers and bankers to continue to assume their traditional risk-bearing responsibility. By the nineteen-fifties, owing to the continuing inability of the developing countries to raise loans on the international market and a progressive shift from a sellers' market to a buyers' market for capital goods, export credit insurance was extended first to medium-term credits and then, towards the end of the decade, to long-term credits. Insurance for short-term, medium-term and long-term credits is now provided by all the developed countries with market economies and three of the centrally planned economies viz. Czechoslovakia, Hungary and Poland.

Effectiveness of export credit insurance in developed countries

5. The developed countries' experience has shown that the granting of export credits by suppliers and the financing of such credits by the banking system are largely dependent on the availability of guarantees for the supplier against possible losses and against prolonged illiquidity caused by protracted failure to pay on the part of the buyer. Furthermore, the insurance policy greatly facilitates the mobilization of export credit financing when the supplier is unable to bear the burden of financing the export credits out of his own resources for the full maturity of the credit. This latter role of export credit insurance has assumed unprecedented importance because an increasing number of firms faced with the need to grant more export credits on longer maturities in order to expand their business, have found that they can do so only by seeking more bank financing. The fact that the risks involved in export transactions are covered by government-owned or government-sponsored institutions has also brought about increased participation by banks in the export financing process and has led to the mobilization of funds which would not otherwise have been mobilized for that purpose. Export

credit insurance has become an integral part of the export financing process in the developed countries, its provision being in most cases a prerequisite for the granting and financing of export credits. The effectiveness of the credit insurance in the developed countries depended mainly on their export mix which was mostly manufactured products either consumer durables or capital equipment and/or on performance of large contractual works overseas. This is evidenced by the fact that while the percentage of exports insured in highly industrialized countries like the UK and Japan were 26.8 per cent and 40 per cent respectively, in the smaller developed countries such as Austria, the percentage was comparatively low. For instance, Austria 9 per cent, Finland, Norway and Netherlands 7 per cent and in Belgium, Denmark and Sweden just 5 per cent.

The need for export credit insurance in African developing countries

6. In the case of African developing countries the facility provided by export credit insurance is of particular importance in the context of the efforts now being made to build-up intra-African trade. Most developing African countries still depend for over 80 per cent of their export earnings on primary commodities which are sold to developed markets. They have just now begun the process of import-substitution industries and, since such industries cannot be made viable within national markets boundaries are anxiously seeking markets abroad. In furtherance of this objective, multinational groupings have been formed and trade liberalization measures are being attempted. Complementarities both in the agricultural sphere and in the industrial sphere are being examined. For most African countries exports to other African countries is entirely a new business. It is a question of penetrating unknown markets and contacting importers whose credentials are not known. Therefore the risk involved is very much greater. Besides, to compete with outside products, the African exporter will not only have to be competitive in price, quality and delivery dates, but as a special attraction will also have to offer credit facilities at least as competitive than what the overseas competitors are offering. This is particularly important if the brand-consciousness of African importer is to be broken. In some countries, imports even for raw materials and consumer goods are

allowed only if deferred payments can be arranged. Besides, the intensification of the industrialization of the African countries means that many new traders who are unfamiliar with export practices will enter the export field. Since in most cases credits are granted on the basis of the customer's financial standing rather than soundness of the export transaction, the provision of export credit insurance may provide a suitable collateral security for such exporters to obtain both pre-shipment export credit finance and post-shipment export credit finance. Another major factor is the interest commercial banks will be charging for such export credit finance. Where the risks are greater and where competition for domestic credit is high, the interest rate will naturally be very high. The provision of an export credit insurance reduces risk element thereby enabling the exporter to obtain his finance at a lower rate of interest than would have been otherwise possible.

7. However, it must be noted that, except for Israel where the percentage of insured exports is between 8 to 9 per cent of the annual exports, in other developing countries where export credit insurance schemes have been initiated the percentage of exports insured has ranged from 4 per cent in India to less than 1 per cent in Mexico and Pakistan. It must also be remembered that these countries which have started export credit insurance schemes have had a very much earlier background of industrialization almost beginning with the end of the Second World War, whereas most developing African countries' industrialization had been initiated only in the 1960s. That the percentage of exports insured in the developing countries is comparatively small is not surprising as most exports even from those industrialized developing countries still consist of primary products which have relatively sure markets and are handled through a limited number of channels.

<u>Problems involved in the establishing and operation of export credit insurance schemes</u>

8. The establishment and operation of national export credit insurance schemes in developing countries poses three major problems:

(a) the question whether the potential volume of exports for which insurance will be sought would offer sufficient premium income to provide an adequate working capital and constitute a reserve to cover losses resulting from the payment of claims:

(b) the possibility of setting up an effective credit information service or of obtaining adequate credit information from other credit information services or agencies;

(c) the availability of trained staff to operate the scheme.

The problem of solvency

9. The experience of existing credit insurance schemes in developing countries reveals that such insurance is sought for only a relatively small portion of exports. It would be unrealistic to expect that the premium from such a relatively small portion could be operated, particularly in the African countries, on a self-supporting basis. In the initial stages at least, the government will have to provide sufficient reserves for even the administrative expenses and the payment of any claims that may arise. In the tight foreign exchange situation that most countries are faced with, this may be a poser. It has been suggested that the relatively small premium income can be overcome by the setting up of multinational institutes. This too has its difficulties. Firstly, the basis of participation of various member governments for such multinational export credit insurance organization will have to be negotiated. Secondly, such an institution might face the additional problem of active competition among member states for identical export markets. Thirdly, if the guaranteed fund runs into deficit as a result of losses on the export of one particular participating country, the institution may cease functioning. Another alternative that had been adopted by one Latin American country is for the national export credit insurance organization to reinsure part of the risks involved with a corresponding credit insurance organization in the buyers country. This is possible only as and when export credit insurance organizations are instituted in two or more African countries, particularly constituting a sub-region. This is an aspect, which has to receive an in depth investigation, with projections based on a dynamic view, of likely developments of the factors mentioned in paragraph 6.

10. Any attempt to finance the scheme by charging high premiums to counter-balance for the small volume will be self-defeating. It will make the export non-competitive. Secondly, the high premium rate will discourage the exporter from undertaking possible export transactions which by their very nature are risky. For the exporter, the premium that he has to pay has to be

a marginal factor. If he has several export markets, he would not venture at a lesser profit to enter into unknown markets. Ideally, the premium to be charged, both for commercial and non-commercial risks, should not exceed 1 per cent. This low premium would in turn mean a large extent of subsidization.

Credit information service

11. The efficient operation of any export credit insurance scheme clearly depends on the ability to exercise due business prudence regarding the soundness of the export transactions for which insurance is requested. This, in turn, depends on the availability of adequate, reliable information on the exporter, the prospective buyer and the prospective market. Obtaining such information and classifying it systematically involves not only financial factors, which are bound up with the question of solvency discussed above, but also with technical factors.

12. The collection of information on the exporter may not involve too many difficulties, but the collection of information on foreign buyers and markets is a much more complex process. When an insurance institution assesses a potential buyer's credit-worthiness, it investigates his financial resources, commercial standing, business morality and legal status, general business experience and familiarity with the line of business concerned, the overall situation in that line of business, measures taken by the government of the buyer's country that may affect the buyer's position (for example, discrimination between nationals of the supplier's country and other aliens), and also the fiscal policy of the buyer's country as it affects the buyer and his activities (for example, heavy taxes on the type of industry in which the buyer is engaged, designed to channel investment away from that industry into other fields deemed more profitable to the national economy). Such type of information may not be readily available particularly for importers in developing countries, who themselves may be newcomers. Initially, the institution would have to depend on the commercial intelligence network of its banking system and work in close collaboration with it.

Staff

13. The establishment and operation of a national export credit insurance scheme calls for a nucleus of highly specialized staff. The nature of the task requires thorough business knowledge and the continuous exercise of due business prudence in the taking of decisions involving relatively large sums of money. Losses due to inefficient underwriting practices would be particularly serious in the case of developing countries which would be making certain financial sacrifices in order to operate an export credit insurance scheme. It is therefore essential that the senior staff should be of the highest technical and administrative calibre. Experienced expatriate staff may have to be recruited on the firm basis that their places will be taken by local counterparts within a stipulated period.

Problem of credit

14. There is one other consideration which should also be borne in mind in the initiation of export credit financing through export credit insurance policies. The provision of credit to the exporter has two aspects, domestic and external. For domestic credit, in countries which are engaged in the process of economic development, there are frequently competing claims on the restricted supply which often leads to tight money and high interest rates. In this context exporters find it difficult to obtain financing. Even when they do succeed in obtaining credits, the high interest rate charged make it more difficult for them to compete with suppliers in countries where financing is available at much lower interest rate. If, therefore, export credit insurance is to facilitate export credit financing on the domestic front, governments should give particular consideration to the problem of providing finance for non-traditional export activities at very much reduced rates of interest. Most governments which have introduced the export credit insurance schemes have laid down that such financing should be at not more than 6 per cent interest.

15. The external aspect of export credit financing is the foreign exchange problem that the financing country may face. While export credit financing may benefit the individual exporter and eventually benefit the country as well by promoting exports and thus bringing about an increase in foreign

exchange, it may cause difficulties at the national level since sales on deferred payment terms delay the receipt of export proceeds for a certain period contributing to what may already be chronic foreign exchange shortage. If, therefore such difficulties are to be avoided, some refinance may have to be arranged.

Refinancing operations of the IDB

16. The Inter-Amercian Development Bank has a programme for the refinancing of medium-term export credit for intra-regional exports of capital goods. The list of capital goods are specified, as also the qualifications for being considered Latin American exports. The maturity period of the credit to be financed varies from six months to five years according to the type of goods involved. The programme operates through national agencies specially designated for that purpose by member countries which supervise compliance with regulations at the national level particularly with regard to the nature and origin of the goods exported. The national agency is also expected to bear part of the credit facility extended. Refinance is up to 7 per cent of f.o.b or c.i.f. value.

17. The interest rate charged is 6.5 per cent. Commencing from late 1963 up to 31 March 1967, 14 million dollars had been made available for refinancing. It has been suggested that the scheme should be extended to all durable goods including consumer goods which are sold on the international market with maturities more than 180 days'. The African Development Bank might be requested to provide similar facilities and to assist with technical advice, as well as to arrange for commercial intelligence, if member countries deem it advisable.

The priority to be accorded for export credit insurance

18. Member governments intending to initiate an export credit insurance scheme will have to consider the priority to be accorded within the several measures that are necessary for promoting intra-African trade. Transport and communications presently are a major handicap. Absence of commercial information is a further obstacle. Existence of separate currencies and external preferences are further difficulties. Competitive price, quality,

delivery dates, packaging, port handling operations, documentation, customs formalities, administrative delays, all require urgent attention. There are also the political factors to contend with. Export credit insurance by itself will not profitably help unless an effective machinery is devised by each member country to overcome these major obstacles.

Conclusion

19. Where member countries feel that a start with the scheme has to be made, the organization for it should be as simple as possible. Whatever institutional framework is to be devised, the commercial banks, the central bank, treasury and major insurance firms will have to be brought at the national level and for refinancing the African Development Bank and possibly overseas commercial banks. It would be best if a working group within the member countries assisted by suitable experts from abroad, should devise the insitutional framework and operational aspects. The ECA has requested the Association of African Central Banks to discuss this important question at the next meeting. Kenya is to have an export credit insurance scheme soon and perhaps the institutional arrangements made there can provide a model for other African countries.

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