

FOUR YEARS OF BERNE UNION MEETINGS THE EVOLUTION OF EXPORT CREDIT

Raoul Ascari

*Berne Union MLT Committee - Closing remarks
Seoul, October 2009*

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This note is his reflection on the evolution of export credit as observed during his mandates as both Vice Chairman and Chairman of the Berne Union Medium-Long Term Committee from September 2005 to October 2009. The views expressed herein are those of the author and do not necessarily reflect the views of SACE. The author gratefully acknowledges helpful comments from Alessandro Terzulli and Lawrence Chapman.

As Vice Chairman first and then as Chairman of the Berne Union Medium-Long Term Committee meetings (henceforth the “Committee”), I have had the privilege of participating in the discussions that have shaped our business during this time. Now, as this role is coming to an end, I reflect on those meetings and the changes they have spurred.

I will refer to this business as the “ECA business”. ECA is a well known acronym and a useful editorial devise. However, I believe, ECA is also a misnomer as we are much more than just “export”, “credit”, and “agencies”.

In the past few years our business has changed more than in any of the previous decades of existence. However, not many - outside the restricted circle of ECA practitioners - are aware of that.

The first and most important change has to do with membership. Over the last four years more new ECAs from the so-called emerging markets have joined this Committee; some of them have grown quickly and already support significant export volumes. Their total number will soon be at par with that of ECAs from industrialized countries. A clear signal of the rapidly shifting gravitational centre of the world economy.

The governance systems of ECAs can be classified into three main categories:

- i) Government departments or agencies;
- ii) State businesses managed by private companies;
- iii) State-owned independent companies.

Most of the well established ECAs, representing the largest economies, fall into the first two categories. In terms of volumes they cover a vast share of export credit; in terms of numbers, they are becoming a minority.

ECAs from smaller countries and newly-established ones seem to prefer the “State-owned independent company” model. The reason for such a choice, in my view, has to do with the fact that smaller or less developed countries face:

- i) limited fiscal resources to underpin new State business;
- ii) lower domestic content of export.

Those two reasons make less cogent the rationale for subsidizing the ECAs business.

Independent companies tend to support their business through their own financial assets, often managed by dedicated Treasury/Finance teams; follow more generally accepted accounting standards (even if they do not necessarily respond to specific national regulatory authorities); tend to be more risk-averse and are more open about pricing of risks. Underwriting decisions are usually taken by the companies’ Boards.

ECAs taking risks directly on the State budget usually follow cash-accounting principles; transfer any cash-flow surplus/deficit directly into their State budget; delegate decisions (especially for large transactions) to their Guardian Authorities.

While the three models present profound differences, in the past few years the underlying business performances have progressed in a similar direction. The virtuous long cycle of the past ten-fifteen years (large recoveries from old Sovereign defaults; few claims from new guarantees) has sustained favourable cash-flows.

All ECAs have shown quite remarkable financial results. Some of the improvement is due to the generally benign global environment up until the summer of 2007; some is the result of improved fundamentals. Time will tell the importance of each of the two factors.

Among the fundamental improvements, we must point to:

- sounder underwriting criteria and techniques;
- pricing more in line with underlying risks;

- more active management of portfolio risk;
- effective recovery mechanisms through the Paris Club.

The evolution in governance and business models has taken place in a fast-changing external environment: globalization has been a main driver for change in the ECA world. The Committee has discussed changes in trade patterns, the increasing specialization of the supply chain, the role of transportation/logistics/ information technology/communication in fostering the global integration of production lines.

These trends have moved in the direction of reducing national components of export and making less convincing old underwriting rules and policies based on domestic content. The issues of tied and untied facilities, of eligible and ineligible content have been revisited. Even though approaches still remain quite different, all ECAs have made their eligibility criteria more flexible. Those who have progressed more in this direction now rely on the concept of “national interest” as a guidance to their underwriting decisions.

Underwriting teams and practices have widely improved as the focus has been moving away from sovereign risk (a field where macroeconomic analysis is dominant) to commercial risks (from straight forward corporate risk, to project financing risk, to bank risk).

New underwriting skills have been brought to bear. ECAs have hired specialists from the private sector and introduced new tools such as frontier techniques for assessing and rating risks. The systems of covenants and collaterals for complex transactions have become more and more sophisticated. The analytical links among macroeconomics, sectors and individual counterparties have been explored to better assess risks.

Pricing techniques have also changed, less than desirably from my personal point of view. While the OECD Minimum Premium Rate remains the floor for ECAs pricing, the final premium is the result of different approaches that can be summarized in two “schools of thought”:

- i) those who prefer an “add-on component” to the MPR;
- ii) those who derive a premium from market benchmarks.

The model *per se* would not be relevant if it led to consistent outcomes. The problem is that differences remain too wide among ECAs and one area of specific concern is the so-called

“category zero” (i.e. industrialized countries), where the MPR model does not apply and the OECD rules call for the loose concept of “market test”. Market pricing is like beauty: it is in the eyes of the beholder.

Pricing is an area that will continue to see lack of convergence as different ECAs philosophy and approaches persist. The risk of a new “race to the bottom”, especially at a time of global economic downturn, is high.

Should this happen, many of the improvements seen in the past few years would be lost. At the same time lower premia may not provide a competitive edge as:

- i) they would be matched by other national competitors (especially those who have recourse to the so-called “war chest”);
- ii) they might benefit financial intermediaries (the lending banks) more than exporters;
- iii) they might benefit savvy importers from rich countries, able to pitch one export credit system against the other.

A “race to the bottom” would most affect the financial sustainability of ECAs run as independent companies; while the performance of ECAs that use their Government’s balance sheet would carry on being included in the overall public deficit.

Let us hope that there will be enough restraint to avoid this outcome. Some pessimism, however, finds justification in this Committee’s own experience: one of the few times there has been disagreement, it was on a technical exercise on how to quantify risks and reflect them into premia.

Let me turn now to another area. Portfolio management has been a recurrent theme in our meetings. This approach, actively implemented by many ECAs, entails a better monitoring of exposure (even though ECAs statistical reporting continues to lack homogeneity and is rudimentary in its details), early warning systems on potential claims; quick reactions in case of payment delays and so on.

A few ECAs have tapped the markets to buy risk protection, especially when CDSs were cheap and the counterparty not perceived as risky as it is today. Some ECAs have undertaken swaps among themselves or reinsured each other.

This area, notwithstanding the past experiences, does not seem to offer great potential for future developments. As ECAs remain the insurer of last resort, there is limited re-insurance capacity outside of their world, especially in today's environment. Some exceptions will be possible for specific transactions and limited amounts, but ultimately ECAs will mostly self-insure through large capital and reserves and/or the ultimate recourse on their governments for tail losses.

The Paris Club recovery venue has worked well for the recovery of sovereign claims, helped by the boom that emerging economies have experienced after the crisis of the turn of the century. A little bit of luck has also helped, as most of the old debts were recovered before the current crisis erupted.

The capacity to recover claims outside the Paris Club has yet to be seriously tested in the so far benign economic environment. The current crisis will eventually stress the ability of ECAs to scale-up their recovery capacity outside the Paris Club collective framework. What we know is that ECAs can work together at times of difficulty, as they have done in the Asia Pulp and Paper (APP) case and more recently in the ongoing restructuring of Bank Turam Alem (BTA) and other CIS banks.

The last four years have experienced major innovations in the menu of offered products. Within the traditional Medium-Long Term export credit business, product changes have been introduced in areas such as local currency financing; Islamic financing; products linked to "climate change" initiatives.

Even more changes have occurred outside the MLT export credit, with ECAs now offering quite an array of products (political risk insurance, short term credit insurance, bonding, working capital, financial guarantees to give but a few examples). This broadening of the product range raises some issues, amongst which:

- the OECD regulatory framework, focusing on MLT export credit and neglecting the issues of a pricing benchmark in OECD countries, is fast becoming irrelevant. This would not be necessarily bad, if the current framework of microregulation (e.g. pricing, tenors, content) and the inherently flawed *ad hoc* accounting models (e.g. the so-called Premium Feedback Tool exercise aimed at measuring long term break-even) were to be replaced by an accounting system based on best market practices;
- the BU division among product lines (Short Term, Investment, Medium-Long Term) no longer reflects actual division of labour and causes overlaps among the Committees; as the

massive State intervention in both the short term credit insurance sector and the medium-long term export credit business will clearly impact upon other private players, the need for serious joint discussions across Committees will become paramount.

The Committee has often discussed issues pertaining to the regulatory framework: the WTO rules and most importantly the OECD framework (including pricing, environment, social issues, special exports such as ships, airplanes and so on). The debate on how much regulation is needed for the industry, as stated above, remains an open one.

An important result has been achieved by the Committee in the areas of self-regulation, by agreeing on a set of “Guiding Principles” for ECAs business. The impression though, is that this important piece of work remains largely unknown to the outside world.

The issue of how the BU is perceived by the external world has been often discussed but, in my view, with little progress. One example: while the commercial bank’s Equatorial Principles are well publicized in the international press, ECAs (OECD-driven) approach to environmental issues are known to a very limited group of people, yet in my view the OECD approach to environment is superior to that of the Equator Principles.

This notwithstanding, we are now much more transparent and informative to our stakeholders than we used to be, remaining mindful of the need for confidentiality before the transactions are finalized.

The Committee has discussed the increasing role of Corporate Social Responsibility (CSR) policies and structures within ECAs. The “Environmental Footprint” has been the special theme of the Annual General Meeting in Banff.

What makes ECAs different from market players, according to me, is that we exist because we have a social mission: to promote economic growth through trade. With economic growth come higher income, better living conditions, higher employment, etc. It is quite appropriate therefore that the policies implemented to achieve this higher goal are themselves respectful of, among others, the environment, social issues, sustainable development in borrowing countries.

A private firm goal is profit and we should not be hypocritical about that. Profit is the motivation that drives private decisions. Social Responsibility policies are a production input, like many others,

to maximize profit. If customers ask for CSR and buy or reject a product based on it, private companies must respond. This pressure is of course good and can enhance social welfare.

Thus CSR may mean different things to different people. For ECAs it means that CSR must meet the higher standard rather than lip-servicing, politically correct statements and actions. All projects must incur some (financial, social, environmental) costs in order to generate benefits. ECAs should not pursue the mantra of “zero cost” because that would stall development and growth, especially in the weakest countries. Rather they must strive to minimize, mitigate and compensate costs on individual projects to the extent possible. They should aim for “global positive games” and should be vigilant when, behind declared ethical and social standards, there are efforts of lobbies that simply try to protect some vested interests. We have seen many cases like this in the past.

Above all, as trade promoting bodies, ECAs should recognize that subsidizing one’s country export *vis-à-vis* competitors runs against their “Global Social Responsibility”.

Sustainable/responsible lending, a part of CSR, has been high on the agenda. ECAs have been mindful of the risk that unprofessional underwriting represents for themselves and their borrowers. However, the cooperation with IFIs has been less than successful; their contributions to the works of the Committee have been negligible.

In their underwriting, ECAs have always tried to respect the limits imposed by IFIs to the borrowings of highly indebted and/or poor countries. Understanding how exactly those limits work (by maturity, counterparts, total and per transactions, etc.) has been difficult and the channels of communication not very effective. For the Committee the issue of what kind of relation to pursue with IFIs should be another open issue.

For the first time, the Committee has made strides into non-technical matters such as human resources, recruitment, incentive systems, recognizing that at the heart of the change in our business were a new breed of people and a different approach to their professional careers. Outside recruitment has improved the quality of staff, as have done better remuneration and incentive packages, continuous training and so on. The Berne Union training seminars for ECAs staff have contributed significantly to this end.

The sea-change in ECAs attitudes is epitomized by the new approach to clients (i.e. Know-Your-Customer): greater presence on the domestic territory through local offices; sometimes direct

presence abroad; organization, on a regular basis, of commercial events; regular visits to clients; the introduction of on-line products that make physical distance less of an obstacle. The KYC not only helps understand the needs of the clients, it is also an important tool in managing risks including reputational ones as well as frauds.

The question of who is the client has become key, as export credit implies three different categories of beneficiaries: the exporter; the buyer; the insured. So has been the issue of how to best serve the interests, often conflicting, of those parties.

The Committee has discussed the relations between ECAs and banks during normal times and at the time of crisis, like the one we are currently experiencing. In today's environment, the relationship between banks and ECAs has become particularly tense. Banks have greatly scaled down their lending facilities, dramatically increased their liquidity spreads and shown little or no willingness to share risk.

The export credit market has suffered like many other financial segments. It has become a "seller's market" with fewer active banks and less resources to lend. In such a market spreads have skyrocketed, before coming back down and stabilizing in the last few months. The high return on the little lending that has taken place has concurred to improved quarter profits by many banks.

In the end, what matters for a borrower is the all-in cost of its debt. To the extent that the increase in banks' spreads is compensated by low premia by ECAs, the all-in cost can be mitigated. This seems to have been the case so far in the current crisis: who has benefited from it? What if the rent generated by the low premia goes mostly to the banks that are already enjoying a new profit boom, courtesy of our Governments' subsidies?

The crisis has brought to the attention of the Committee the fact that "pure-cover insurers" are "lame ducks" without lenders; and lenders are fast in taking advantage of that. Banks make profits, in good and bad times; the only exceptions being when they eventually, and rarely, go bust.

Switching to another subject, the agenda of our meetings has always focused on country risks. We have been confronting on: countries' macroeconomic outlook; exposure on countries and borrowers; delays in payments due; efforts in recoveries. Iran has been our main concern, given the large exposure some of us have cumulated there. Many other country or regional situations have also been reviewed.

On several occasions we have discussed our increasing exposure to industrialized markets and we have discovered with some surprise that the main beneficiary of MLT export credit is the USA. Have we reflected enough on this? Can it be that we had a part, albeit small, in the bubble that just exploded in that market? ECAs were certainly not in the real estate bubble; but, you know, money is fungible. If not this, what does it mean when the ECAs main markets are the financially most advanced ones? What about the export we support and its collapse in the last quarter of 2008? If this is not an “export bubble”, driven among others by economic policies that neglected domestic consumption and other export incentives, can it be an “excess supply of export”? And even if there is not such a large issue, should we continue to support exports in industries in advanced countries (ship building, steel plants, airplanes, etc.) which have already vast excess capacity? And will we be happy to do it at the premia we charge today?

The explosion of the “Great Recession”, as somebody defined it in one of our meetings, has pretty much stolen the attention of the Committee from other key issues. The Committee started to discuss it in New Delhi (October 2007, *What is going on in the international credit market?*), and not for a moment failed to realize the gravity of the events; it followed-up in Sydney (April 2008, *The international financial situation: how is the sub-prime crisis evolving?*) and by the time we gathered in Banff (October 2008, *The international financial situation; impact on members’ business*) it was clear to everybody that the situation was in dire. Finally, in Istanbul, we dedicated almost the entire agenda to this topic and moreover, as I close my tenure with this meeting in Korea, the subject is still at the heart of the Agenda.

How surprised are we of this crisis? To me it has always been clear that over the past decade the markets “had gone crazy”; that spreads did not pay for the risks; that covenants were too lax. Some believed that if the private market could take care of demand, it should be allowed to do so. Others were worried that MLT export credit could be done without ECAs. I believed that it was just a matter of time before we came back in business: there have always been market crises and failures, and there will always be.

We now know that accelerated global economy growth has been possible thanks to the functioning of very deep and global financial markets. They have spurred at least a decade of high growth. Today we also know that the same financial markets can work in reverse and cause a devastating crisis.

This situation will continue to weigh on future Committees. In the immediate, the key issue we are facing is that funding has become “the scarce commodity”. ECAs have introduced new tools to tackle this problem: direct lending; refinancing facilities; funding facility for banks; twin programs with other national public banks to offer a complete financial package (loan plus guarantee). As banks are in a de-leveraging process, insurance cover offered can go up to 100% to limit capital charges and the nominal amounts covered are larger than before.

Larger issues however lay in front of us. This crisis will change the borderline between the State and the Market. Before the crisis private markets could fill all the needs at very low spreads and ECAs were becoming ever-marginal players. After the crisis, the State has entered into the capital of banks and is supporting them with huge liquidity injections and through specific facilities like those dedicated to export credit. How will the State exit from this situation? When will it exit? What will be the role of the State and that of the private sector in the next decade?

This discussion will continue in the future and the Committee will have to reflect on some complex issues:

- Will ECAs, in an effort to respond to market failures, take too large risks, too little remunerated? By doing this, will they jeopardize their own future?
- Will the new emphasis on export and jobs alter the level-playing field? Will this start a “race to the bottom”?
- What sort of relations will develop between banks and ECAs? Will ECAs crowd-out the private player and make it harder for them to come back, for example by replacing private lending with public?
- Or, at the opposite end, will ECAs be just another tool to subsidize profits of the savvies, be they banks or buyers from rich countries? Will ECAs offer additional subsidies, besides those originating from other State measures?

In the last years we have experienced a collapse of historical intensity of the market economy. The “animal spirits” running loose have created great havoc. The result has been a huge transfer of losses and liabilities from the banks to the States; the collapse of the banking system has translated into the widespread public debt crisis.

Markets must be subject to scrutiny and criticism when everything is working just fine. They need to be protected, even from themselves, when they are under attack. As it was said of democracy, “market economy is an imperfect system, but everything else that has been tried has miserably failed”.

Nobody denies that government intervention has saved the world so far. But the saviour must be controlled before he becomes a tyrant. Public intervention is needed but not to substitute the market. The role of the State must be timely but also targeted and temporary.

As big as private market failures are, State failures can be and have been of much greater proportions. At this time the “bureaucratic spirits”, including those harboured in the ECAs’ world, must be kept in check.

As representatives of this world, we need to stand by strong principles even more than in the past. These principles, in my view, are the following:

- do no harm and avoid altering the level playing field;
- do use public resources effectively. Financial losses are always real and represent a consumption of taxpayers’ money; “social benefits”, always difficult to measure, are often unlikely to be realized;
- do not jeopardize the future of the company, even if this means to protect it from short-sighted political pressure.

This note is my personal summary of four years of Committee work. As the saying goes: everybody will agree on something; and somebody will agree on everything. Certainly everybody will not agree on everything.

What is important is not that we disagree, but rather that we continue to discuss and debate in an open and friendly manner, as it is and as it has always been for this Committee.



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