Is Export Credit Agency A Misnomer?
The ECA Response To A Changing World

Raoul Ascari

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Raoul Ascari

CFO, Sace°

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Abstract

Changes in the global economic and financial markets and the increasing role of the private sector in the economy are among the factors triggering a change in the export credit insurance business model. Against this background, export credit agencies can stick to their traditional role of insurers of last resort and have a marginal (though well protected) role or change to become a global financial player helping growth and trade. The recent experience at SACE shows that the latter is a possible strategy, but is not without challenges and risks.

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° Corresponding address: Piazza Poli, 37/42 - 00187 Roma. E-mail. r.ascari@sace.it

1. Introduction: the challenges for export credit insurance

Export Credit Agencies (ECAs) have traditionally been seen as a tool for governments to support national companies in their export business and enhance the economy's capacity to penetrate foreign markets. Since 1919 when the first agency was established in the United Kingdom with the objective of guaranteeing exports to markets not covered by private insurers, ECAs have been insurers of last resort against political risks and commercial risks that were not deemed insurable by private markets.

The rationale for establishing an ECA, however, has never been spelled out in a definitive way. While the theoretical underpinnings and empirical results of ECA's activities at times have been subject of scrutiny, economic literature on this line of research has almost disappeared over the last two decades. It was in the eighties that academic interest in export credit was at its highest. As an indication of the debate at the time, a paper published by The World Bank Research Observer in 1989 lists the different rationales behind export credit:

- capital market failures: this can be broken down into incomplete information on export risks; limited or segmented access to credit by riskiest or smaller borrowers; weak financial structures or even government policy failures;
- risk, uncertainty, and incomplete insurance markets: those are factors that can create a wedge between the risk and the "reasonable" premium needed to cover it;
- moral hazard and adverse selection: although not necessarily market failures, they are an inherent feature of risk and may rise premium above the threshold at which exporters are willing to buy insurance;
- industrial policies: emanating from the theories on the "strategic trade" rationales based, for example, on economies of scale or rents in imperfectly competitive markets;

- export externalities: associated with production for the export market, causing divergences between private and social costs and benefits;
- employment and the balance of payments: unemployment and trade deficits have also been pointed to as justification for export credit and insurance programs;
- matching other countries' programs: this is the rationale for the "war chest" on the trade arena, where export subsidies are often coupled with other instruments such as development aid.

The neglect by academic literature of the role of the ECA as a policy tool in the last twenty years can be explained by a host of reasons: the failure of many of these programs around the world, resulting in huge defaults and debt restructuring by borrowing countries, especially within the Paris Club context; a new vision of the world –stemming from the fall of the Berlin Wall, the Washington Consensus and Reagan and Thatcherite economic policy inspired by liberalism- centred around the role of markets and private agents in the growth process of both industrialized and developing countries; limitations imposed by individual countries and supranational bodies on State aid.

During this period of academic neglect, the ECA world has greatly changed. Following substantial reforms arising from the crisis of the nineties, the new direction taken has barely been noticed outside the export credit community: the OECD, with its new set of regulations, has imposed stricter and more conservative financial policies -by mandating for example the goal of break even- and sounder economic and social underwriting –minimum pricing, environmental issues, bribery prevention, etc.-; the Berne Union has seen its membership grow as new players, both public - from emerging countries- and private, joined the Club, while at the same time competing and cooperating in the market arena; national governments have taken different approaches to public export credit, by enforcing better financial discipline, pushing for higher quality products and services, increasingly accepting

rules of the game dictated by supranational bodies aimed at creating a “level playing field”.

As a result of those factors and a considerably more benign international environment, the ECA’s world has turned the corner, moving from decades of high losses and negative cash flow, to a decade of operational profits and strong debt recoveries. However, the question of “what is today an ECA?” is rarely debated. This paper tries to address this question still in a preliminary way as, today, there are probably as many answers as ECAs. In general, the ECA is moving away from the old model of “public insurer of last resort” –that responded to one or more of the rationales summarized above- to something different yet not totally or singularly definable.

The economic developments in the last decades are challenging the traditional role and business model of these agencies. Global trade and financial integration, structural transformation in production organization (i.e. delocalization), and, the increasing role of the private sector in deregulated markets have limited the scope for traditional export credit support and opened the market to new business models. This transformation has not yet reached its final stage but different approaches have emerged[1].

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[1] Looking back to the history of export credit, some of the features emerging today have been present before; the swings in the ECAs role has been ample since the onset of the first ECA. In 1933 the US Eximbank was created and in the period following World War II most countries created their own export credit guarantee instruments. In 1961 the Foreign Credit Insurance Association was formed to insure U.S. exporting companies against defaults by foreign buyers and political risks. The FCIA was originally an association of private insurers operated in cooperation with the Export/Import Bank of the United States, an independent government. The private insurers underwrote the commercial risks while the Eximbank covered the political risks, until the private sector withdrawal from operations left Eximbank to cover both risks. The progressive entrance of new private players in the export credit and political risk insurance (PRI) is thus not necessarily a fact of today. At the same time, the program run by the Japanese Ministry of International Trade and Industry (MITI), that covered about 37% of total Japanese exports in 1983 was successfully run on a self-supporting basis. Indemnity payments were made from a special insurance account created

In this paper I discuss briefly the traditional role of ECAs according to the prevailing economic rationales that supported their creation and development especially in mature economies (section 2); then I look at some of the industry features of the more traditional ECA business (medium long term export credit especially for large projects in high risk countries) with a view to understanding how much of this business can, in perspective, be left to the private market (section 3); as a synthesis of the previous analysis I look at the challenges for export credit support institutions in the new global financial and economic environment (section 4); finally I present the case of the Italian export credit agency SACE and the ongoing transformation from insurer of last resort to global player as an example of challenges and opportunities for export credit market developments (section 5). I conclude with some issues on the future of the export credit and financial credit insurance business that, in my view, deserve further research and discussion (section 6).

2. The traditional role of Export Credit Agencies

Originally, export credit support was established as a response to market failure. The financial losses incurred by such a program were offset by the economic gains (e.g., an increase in aggregate utility for a society). One of the main justifications for export credit is to be found in the lack of adequately developed financial markets, and the resulting difficulties of emerging/developing countries in obtaining financing at the right terms and conditions. The answer to this problem, however, carries an inherent difficulty: while the failure affects mostly emerging countries, the solution rests mostly on advanced countries and the risk is that the involved subsidy is transferred from the exporter (and its national taxpayer) to the buyer.

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through received premiums until the debt crisis of many developing countries turned the tide and the program started to incur losses for the first time since it was started in 1950. A self-sustainable and financially healthy ECA is also a feature that can be found in the past.

While *prima facie* the subsidy transfer implicit in the “capital market failure” rationale may seem to entail an element of altruism, in fact the justification for an export credit program can be found in the efficiency arguments based on the concept of public good. If export credit insurance is of public benefit on account of the positive externalities it entails (especially for exporting industries), then it is justified for governments to establish agencies that would support export by protecting against risk the private sector is unable or unwilling to cover. The financial costs (subsidy) of such a program would in fact be offset by social benefits. The production for export markets has often been associated with higher quality goods that require research and generate innovation. Benefits accrue to the exporting country in terms of competitive firms that operate on the technological frontier, generating foreign revenue and additional employment, thus justifying taxpayer’s money, the ultimate source of finance for government activities.

During the oil crises of the seventies and eighties, the role of export support in industrialized countries as a stimulus to employment and balance of payment was paramount, especially in countries suffering from persistent loss of competitiveness stemming from high inflation. While theoretically the macroeconomic impact of export credit policy remains highly controversial (both in terms of its “multiplier effect” and the distortions it can induce on allocative decisions), overtime it has lost its practical importance as many countries have improved their framework achieving fiscal stabilization and sustainability through macroeconomic policies rather than industrial policies. Furthermore, greater limitation to State aid has been enforced through international legislation (including European policies).

In the mid-eighties, on the basis of the new ideas originating from Strategic Trade theory and the experience of export-led emerging Asian economies, export support started to be justified on the basis of its ability to sustain export-driven growth and support the creation of *National Champions* in key strategic sectors by helping them

overcome the barriers to entry erected by monopolistic and oligopolistic incumbents (e.g. the aircraft industry). In the last decade, which coincides with the explosion of the emerging markets (an upgrade, at least in terms of jargon, from the previous status of just developing countries), export support has been seen as a tool of the Grand Political-Commercial Strategy for conquering big markets. The use of this tool has been sustained, for example, by the book "*The Big Ten*" by J. Gartner, the then Undersecretary of Trade in the first Clinton Administration, and applied by the frequent Trade missions organized by Heads of State to promote their companies in the big emerging markets.

In summary, a host of factors have been called upon to justify an export promotion tool (through export credit and export credit insurance). That such a tool implied a subsidy became indeed evident in the eighties and nineties, when ECAs paid huge claims for emerging countries defaults. The hefty debt prepayment of the last few years have mitigated the huge losses, although in present value terms the cost to taxpayers has remained high. Most of the debt vis-à-vis African countries has been written off; partial (but substantial) write offs have also occurred for countries like Egypt, Poland, Yugoslavia, Iraq, Nigeria; other countries have recently fully or partially repaid their outstanding debt (Russian Federation, Algeria, Brazil, Peru, etc.), but even those cases have involved losses in opportunity cost terms, as most of the time the interests on restructured debt have been set well below corresponding discount rates. On aggregate export credit has caused a major financial loss to the concerned States; whether it has been adequately compensated by economic benefits it is hard to say and is largely outside the scope of this paper.

Due to the fact that export credit entails a subsidy and its resources are limited, it requires rationing through strict rules and regulations. Export credit has been, in most ECAs programs, strictly tied to national/domestic interests usually defined according to the following concepts: a) national exporters (locally registered companies); b)

domestic exports (products with a very high component of goods and services of local origin); c) goods shipped only through national carrier (the case of the US).

In some cases however (i.e. small economies) such limitation was hardly enforceable. For economies highly integrated in the world system of trade and investment, the limits to the domestic content would have made national ECAs irrelevant. Rules had to be relaxed since their inception and the overall contribution to the export of the country and its economic development and growth process had to be redefined more loosely. The smaller or the more uncertain the direct benefit on the economy, the less justifiable becomes an implicit subsidy and the use of public funds. The trade off was obvious: a less stringent use of the export credit tool could only be possible in presence of a lower default probability of the underlying transaction. Those ECAs had to work under a binding financial constraint if they wanted to stay in business without public recourse and the "acid test" for decision became the quality of each individual transactions.

In the light of the above, we can identify two alternative business models that have characterized ECAs in the past and to some extent continue to do so today: the traditional business model of the *insurer of last resort*, i.e. an insurer that provides a subsidy strictly aimed at its national exporters and tries not to interfere with the market, leaving to the private sector all marketable transactions. This player focuses on countries and transactions for which the market is unable to offer solutions: riskier countries; non-recourse projects; long-repayment terms; bulky exports. This insurer is also very active in the sectors where its National Champions are operating. Its overall portfolio remains unbalanced (operating only or mostly on non-marketable segments) and its overall risk is eventually unloaded on the overall Budget of the State. In this context, the export credit insurer is a public Agency or a private company that acts on behalf of the State. The second model, as we will see further below, is that of a player that tries to operate like a private company, combining its mission to support its

national companies with the need to be flexible and open to transactions where such an interest is not so dominant; a player that must not use public resources on loose economic goals but must run a self-sustainable business, as proved by an independent status, transparent financials, positive financial results.

3. The changing global economic environment: a new role for ECAs?

While the traditional model is pretty much alive in many countries, the events of the last decades that are commonly summarized with the concept of globalization have led to a rethinking of the roles and strategies of export credit insurance institutions. There are at least four important developments that have contributed to this process:

- the growing importance of emerging markets. If the market failure is the result of capital markets underdevelopment (both domestically and internationally), as countries grow and become more integrated worldwide, such a failure tends to become less severe and ultimately disappear. To use the jargon of the International Financial Institutions, countries tend to *graduate*, first from development aid and then from other forms of subsidized financial transfers. ECAs should accept a decline of their role and, ultimately, the end of their *raison d'etre*. Obviously there will always be countries with high political risk (Iran, Iraq, North Korea), or countries that will change their political course (Venezuela, Bolivia), or that still represent a development challenge (Sub-Saharan Africa). However, their number and relevance will diminish over time. Even today, some economists argue that emerging markets is an obsolete concept.

- The changing nature of emerging economies: without embracing the determinism of the End of History views (i.e. all countries will turn at some point into a democratic market economy), the empirical evidence proves that countries that embrace the virtues of the market perform better than countries that do otherwise.

The more market-based an economy the deeper its integration in the world trade and financial system and the faster its growth. As a corollary, its private sector will grow stronger and more developed and will be able to access directly international capital markets and develop its own domestic capital markets. With the end of financial repression, the role of the State as a borrower declines at the same time as fiscal and current account balances improve. In today's global economic environment, with historically high commodity prices and the transfer of wealth from industrialized to emerging countries that this entails, this trend has been further accelerated.

- The increasing sophistication of capital markets. While the poorest countries often do not have a choice, as countries become more developed they can find alternatives to export credit on financial markets. Today an export-related risk can be managed and covered in many ways: it can be securitized; offset by a credit default swap; insured on the private market; and finally it can be covered by an export credit guarantee. The ECA no longer enjoys, on many markets, the position of monopolist (albeit of last resort). The boundary between a market player and an insurer of last resort becomes foggy: there are cases where only one of the two is present; but in the majority of the case the two operate at the same time, often on the very same transaction. The challenge is for export credit to be sufficiently flexible and tailored to the need of the customers, something that is made difficult by the many rules and regulations that affect it.

- The increasing integration of manufacturing. As a consequence of de-localization, sourcing takes place on a global scale. For those small national economies that started already with a low export domestic content, the trend of the last fifteen years has consolidated an already existing situation. For economies whose multinationals have long since de-localized on a massive scale (e.g. Japan), the issue of how to assist subsidiaries in third countries found political and technical

solutions many years ago (e.g. by extending the support to the exports of affiliates from third countries). Other countries are increasingly coming to respond to the new needs of their exporting companies, but also new commercial opportunity to expand their scope of action.

The business model required to deal with these changes is very different from the traditional insurer of last resort. Against the background of trade integration and a deepening financial system many ECAs have transformed (or better are on their way to) into a *quasi-market player*, that conducts its business on the basis of commercial practices, albeit backed by public capital. This is usually a company striving to be profitable in order to: a) use public capital in an efficient manner (this constraint works both ways as it avoids the recourse on the Budget and allows the company to maintain its independence from political interferences); b) avoid unfair competition vis-à-vis the private sector via hidden subsidies. For the players that have adopted this model the definition of Export Credit Agency becomes a misnomer: their products are broad-ranged (reaching outside export and credit only); they are no longer agencies but rather joint stock companies with independent and financial accounts, and a certain ability to carry risks directly on their books.

In moving into these new areas, there might be the risk of crowding out private players. In reality, ECAs work with the financial sector in a number of different ways and the relations can be both cooperative and competitive in nature. As the key tool is an insurance guarantee, most of the time underlying ECA intervention covers a loan from a private lender, as in the case of the buyers' credit business. Thus it can not be simply stated that ECAs activities (old and new) crowd out the private financial players; rather they broaden the range of instruments available to exporters, often combining their tools with the products of other financial players, thus improving the gamut of solutions available. Even in the case of guarantees on bonds issuance, banks are still needed in the structuring of / subscribing to/ and distributing of the security.

While new or enhanced tools may be a substitute for other existing financial products, they are not *tout court* a substitute for private player.

While operating in the traditional export credit sector, many ECAs act under the umbrella of the OECD agreement. Today many ECAs offer other products that do not fall under the OECD, such as guarantees for FDI, bonding or working capital. In introducing new products, ECAs may enlarge the spectrum of activities that fall into unregulated areas, even though the new programs must still comply with broader principles and regulations; i.e. EU regulation on State aid and in general with WTO provisions on fair trade. In summary, <u>the broadening of ECAs activities must meet two key criteria</u>:

- it must not provide a subsidy for exporters, in line with the OECD agreement (and EU regulations);
- it need not displace private financial players as the guarantees normally require an underlying loan from the banks.

<u>The acid test for the viability of such an approach</u>, is that ECAs must generate a profit and must show for each product that the pricing is market (or risk) based. If those two criteria are met, the traditional line of demarcation of an ECA business (marketable and non marketable) looses much of its meaning: emerging markets are rapidly developing and industrialized countries may still benefit from some limited export credit intervention. In many industrialized countries there are borderline transactions, that may not find adequate support from the private sector alone, either because they are too large, or the required repayment term is too long, or the banking industry is overexposed (not necessarily on the same company, but on the sector). At the same time, in non marketable countries there can be projects that, adequately structured, may become marketable and supported even without ECA intervention. Furthermore, what is today a marketable country may tomorrow become non marketable, in

presence of a crisis (e.g. Asia in the late 1990s). In summary, the old distinction between marketable and non marketable is losing its meaning in a world where many different subjects in emerging markets access international capital markets (governments, corporates, banks, structured deals) and new forms of borrowing are available (foreign lending, domestic lending, international and domestic capital markets, etc).

ECAs can choose between being an *insurer of last resort* or a *quasi market player*. In the first instance, ECAs should withdraw from emerging markets as soon as they obtain access to capital markets and refrain from any transaction where the financial sector is ready to offer a solution (whether or not it is the most efficient one); in the second case ECAs must stay open to all possible situations, always deciding on a case by case basis whether there is rationale for intervention and providing support at conditions similar to those offered (or that would be offered) by the market. In the context of these prevailing trends, the divergence among the two groups of players will widen: the *insurer of last resort* will be more and more relegated to marginal markets; the *global player* will find more and more opportunities to expand. In order to be able to seize the opportunities the *global player* will face tough challenges: a) operational: can a structure, created to deliver a public service, develop the right set of products and the necessary skills?; b) institutional: will the rules and regulations (the mandate, the legal framework, the governance system) be flexible enough to accommodate the changes that are required.

4. The export credit industry: an insurable good?

The presence of an ECA entails some form of market failure, even in a world of ample and movable capital flows. If the expansion of private solutions is unbounded, then the role for ECAs will decline progressively and eventually be relegated to a marginal role. But how realistic is a scenario of unfettered progress of international

markets, with disappearing market failures that make the intervention of ECAs no longer necessary? The answer can begin to be seen in the analysis of a typical/traditional ECA's portfolio presenting the following characteristics:

- transactions located in the riskiest countries, often emerging from or in the mist of economic or political havoc;
- transactions providing cover in sectors that experience private sector withdrawals (i.e. because of excessive exposure or other risks);
- transactions with very long repayment terms (sometimes over seventeen years);
- transactions of very large size (sometimes in the order of billions of euro)
- transactions of high technical complexity (long and difficult construction phases)

Obviously not all transactions present the features above described; however especially for the most traditional ECAs those are the dominant characteristics. Many ECAs have an exposure to the first country or borrower or sector well above 10% of their portfolio; their portfolio on average has a duration over 5 years; the average rating tends to be well below investment grade. Would such a portfolio be insurable by a private insurer? *Prima facie* the simple answer would appear to be "*no*": the risks that are covered by ECAs are not insurable by the market. However, we can try to respond in a more articulate manner by taking one by one the concepts that define an insurable risk, focusing on those "actuarial" in nature (the definitions are from Berliner, *Limits of Iinsurability Risk* 1982, as discussed in Sigma (2004)).

- The risk/uncertainty must be measurable. The risks for an ECA are mostly measured by the ratings -internal or by specialized agencies- assigned to individual transactions or borrower. As the transactions have long maturities and evolve over may years, are based in difficult countries and related to difficult

projects, the stability of such ratings over the life span of the transaction is not constant;

- The loss occurrence must be independent. The portfolio of a typical ECA, as mentioned above, tends to be concentrated in a few countries, or sectors, or borrowers; furthermore, the underlying risk is driven by economic and financial events that tend to be increasingly correlated across countries thus making the risk event increasingly correlated;
- The maximum loss must be manageable. Given the concentrations present in a typical ECA portfolio, the default on the largest position may often be much in excess of 10% of total exposure and thus it absorbs a large share of (notional or real) economic capital;
- The average loss must be moderate. The variance of losses can be very high. For many years, ECAs have experienced heavy losses; more recently the situation has improved and some ECAs have almost been a "zero loss" insurer. The concept of "average" depends very much on the defined time span.
- Loss frequency must be high (for the Law of Large Numbers to apply). The comments made above clearly point to the fact that ECAs are not at all operating in a probabilistic environment;
- Moral hazard and adverse selection must not be excessive. For the fact that ECAs are (or are seen as) insurer of last resort, they tend to attract the most difficult transactions, whereas less risky transaction are handled by private players or self-insured.

In summary, especially on the basis of the "actuarial" group of variables, ECA typical business can not be defined as insurable by the market[2]. This does not mean that the

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[2] Berliner's list includes other criteria such as "market determined" and "societal". The first group has to do with: i) premiums that must be affordable for the insured but also for the insurer (allowing adequate rate of return). ECAs tend to apply premiums aimed at break-even or below what the market would charge. In fact for many typical ECAs's transactions there is no private price

ECA business can not be conducted in a profitable way, rather that its fundamentals are such that the private players may not be willing to undertake it. It would require a very large economic capital to sustain high and prolonged losses, that might be offset by recoveries and profits only over even longer time spans. ECAs' business can be profitable, as today's experience seems to show, but on very long time horizon. The ECA business relies on time diversification with large swings in profits and losses that a private player, subject to shareholder/stock market pressure, can be hardly in a position to afford.

5. From insurer of last resort to global player. The case of SACE

At this stage we can try to bring all the analysis to its fruition by trying to answer what an ECA could or should be in the new global world, and we can do so by summarizing a few findings and then illustrating a real experience, that of SACE, the Italian ECA.

- First, as long as there are transactions that exceed what the private market is prepared to cover (because of their size, duration, complexity, country of destination) at a reasonable (or at any) price, there is a role to be played by ECAs;
- Second, the fact that such a role in the past has caused huge losses does not necessarily imply that ECAs must always be loss-making; over the long period many losses have been recovered (especially through the Paris Club) and in the last years ECAs have experienced a positive return on their underwritings;

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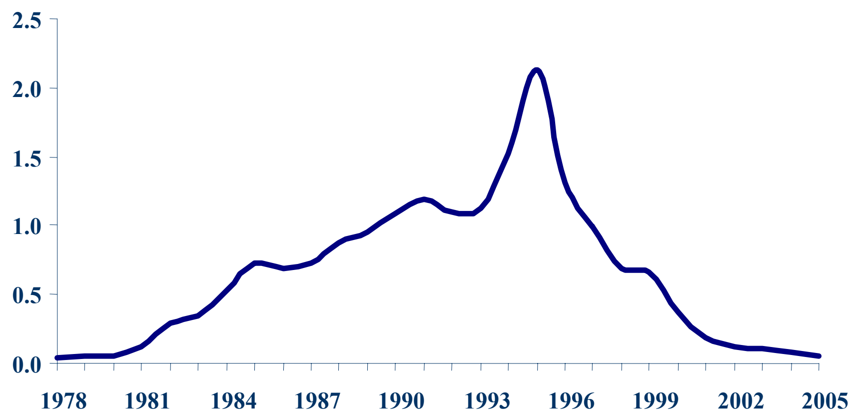
benchmark, and even if there is one, it is likely to be based on few cases as the market for those transactions is not deep; ii) cover limits that can be acceptable by insurers (clauses, regulations, restrictions). Here the restrictions imposed by ECAs are increasing, as they range from economic and financial issues, to social and environmental, etc.; iii) the capacity in the industry that must be adequate. By definition, there is an ECA intervention because the market is not capable to offer a complete solution. The second group requires that the risk covered be consistent with societal values and must be legal.

- Third, the key to remain profitable (if only marginally) rests with the quality of the underwriting and experience seems to show that financial discipline can be enforced upon ECAs through policies (national directives and international regulations) but also through reforms that increase responsibility and accountability.

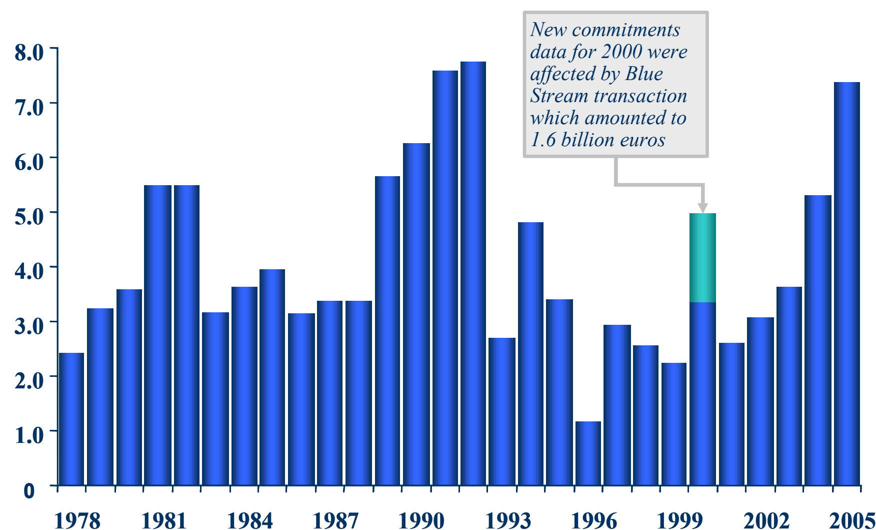
Historically SACE has acted as an insurer of last resort. The weak economic fundamentals of the Italian economy generated strong pressure to use export credit as an industrial policy tool, to boost jobs and foreign exchange. While the economic benefits of this approach remained elusive and difficult to measure, the lack of strong risk control limited accountability and left the Agency exposed to the downside risk stemming from deteriorating market conditions. When this eventually occurred, high defaults were experienced. The payment of claims came directly from the State through the yearly Financial Law, and further exacerbated the public deficit situation at a time when Italy was trying to meet Maastricht criteria. The Figure below illustrates the point.

Fig. 1 - Claims Paid 1978-2005 (€/bn)



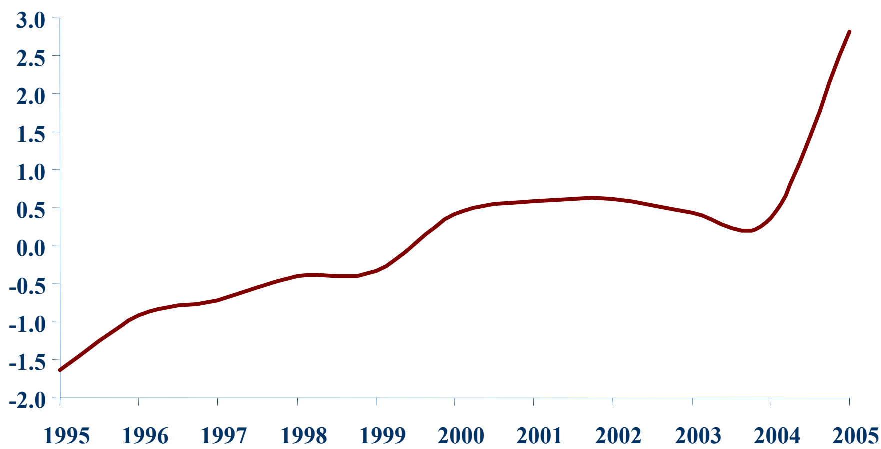
In the mid-nineties SACE was a moribund Agency: saddled with claims, a burned out reputation, staff lacking skills and motivation, loose control on future risks. Its closure, no matter how politically unpalatable, was a real option. Eventually a new management was put in place with the task of stabilizing the situation by limiting new commitments, introducing better evaluation processes, reforming the governance. As a result, new claims were contained but commitments also collapsed.

Fig. 2 - New Commitments 1978-2005 (€/bn)



As often, success depends on good policies and….good luck. In the second part of the nineties a new trend emerged: repayments, especially those stemming from Paris Club restructuring, started to exceed new claims. This offered the opportunity of using the positive cash flow to build provisions against new guarantees. The concept was that by building its own reserves SACE would: a) eliminate the risk of a sudden financial drain on the Budget and, b) become more accountable. New risks could not be taken without the necessary capacity to reserve for them and new guarantees would have to be assessed in terms of the risk and reserve requirements.

Fig 3 - Net Cash Flow (Premiums+Recoveries-Claims; €/b)



At a result, an entirely new mind-set was put into place; a new system of incentives was now regulating SACE's activity; the cash flow continued to improve not only as a result of both lower claims and higher recoveries but also better underwriting. All this created a framework for revived growth; in order to be a lasting development, the business had to be underpinned on a solid institutional foundation and a new business model. In the year 2000 SACE introduced its first *Business Plan* based on the following pillars:

- As the world had changed dramatically, the new growth in commitments had to be delivered in a very different environment which required, among others, new skills and motivation. A recruitment effort was put in place to achieve the right mix of human resources; training programs were developed; a new remuneration package for both staff and management was introduced to reward results (e.g. MBO system).
- Customer satisfaction was the key target to be pursued though growing commitments, a diversified product range, and an improvement in the quality of the services rendered. A whole new set of products was introduced to better serve the needs of Italian exporters.

- In order to run a sustainable business, the capacity to provision and reserve could not only rely on recoveries, but on better pricing policies (price-to-risk) and risk management. This in turn implied greater diversification of the overall portfolio both by reaching new markets and introducing new products, as well as by modern techniques of risk management.
- All those changes had to be reflected in a new corporate governance and in a new mandate that consistently would enable the company to fulfil a public mandate, while applying behaviours and policies in line with best market practices, aimed at an adequate remuneration of its capital base.

The changes set in motion were self-fulfilling. One decision led to a subsequent one that reinforced the former: if the business had to be sustainable the portfolio had to be diversified (an *insurer of last resort* has no control of its portfolio); diversification required a proactive approach both in seeking new opportunities in the traditional segments but also in penetrating new markets; this in turn implied a commercial attitude nowhere to be found in the old monopolistic public Agency; it also required an institutional mandate to allow the flexibility needed to follow the market and the skills to implement it. The consequence of this approach was that:

- every new commitment had to be backed by adequate economic capital and reserves; the growth of the Company needed to be financially self-sustainable;
- as no new capital by the Government was envisaged, the Company had to at least break even on traditional (export credit) activities and generate a profit for other transactions;
- in turn, this approach required that risks be underwritten selectively and adequately priced;

The impact of the new changes can be gauged from the following figures: new commitments, that had been stagnating around 3 billion Euro for several years,

started to grow and surpassed 7 billion Euro in 2006. While the core business has remained that of export credit guarantees, revamped traditional products have started to contribute more to the bottom line (investment cover for political risks, bonding); new products have begun to enjoy market acceptance (working capital, credit enhancement/credit insurance). Old products are now being applied to new markets, and new products to traditional markets, enlarging the scope of the company. In the traditional export credit sector SACE has moved from the concept of support for what is *Made in Italy* to that of support for what is *Made by Italy* (i.e. transactions that support Italian export and investments by agents that not necessarily are based in Italy). The product mix has broadened to areas other than export credit, such as credit enhancement, working capital, bonding, foreign direct investments and their financing. Further developments will occur in the areas of domestic and international infrastructure linked to international trade[3].

The area where the most profound changes occurred was the short term marketable business, with the introduction of a dedicated credit insurance company (SACE BT). As the strategy to better support the Italian business community took shape, it was obvious that the export structure was still very much oriented towards industrial markets (i.e. OECD) and consumer goods (i.e. short term payment terms), a market segment where ECAs are not allowed to operate by international regulations. Yet this market segment seemed to be not fully covered by private players: Italy, with more that 150.000 exporting firms, enjoys a very small (and oligopolistic) credit insurance market, with the three key players (Euler-Hermes, Coface and Atradius) serving overall only 11.000 firms (not all of them exporting). There are probably several reasons to explain such limited coverage, one for example is that in Italy factoring is

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[3] As SACE remains a government-owned entity: the approval from Guardian authorities and specifically from the Inter-ministerial Committee for Economic Planning (CIPE) is required before any new line of business that falls outside the current mandate can be introduced (this was the case for the move to the concept of support for what is *Made by Italy*).

an important alternative to credit insurance. But an even more important explanation is that dominant players may not be interested to cover the most challenging segments of Italian markets, and especially SMEs, because of the (perceived) low profitability of the segment[4]. In order to offer an answer to this challenge, SACE created a specialized subsidiary SACE BT. Although supported by public capital, SACE BT is a market player: unlike the case of SACE SpA (the ECA parent company) its insurance products are not counter-guaranteed by the State, it responds to the national supervisory body (ISVAP), it follows market reinsurance best practices, and it must provide capital remuneration in line with the market. With this development SACE has become a Group able to offer full support to Italian exporters and their affiliates overseas, covering the traditional non marketable sector, the established marketable (short term) business, as well as new activities that present composite features. In doing this the Group has to walk a fine line, avoiding any relations between the two companies that might be or be perceived as a cross-subsidy from the mother company to the subsidiary, in respect of the regulations on State aid. All the transactions between the two companies are therefore at market terms and all contracts for services provided among them reflect best market practices.

SACE BT follows its own strategy and business plan. It has recently acquired an Italian bonding company to broaden the spectrum of products offered and it is pursuing options to increase its distribution channels in Italy, establishing a market presence abroad, consolidating upstream activities in the credit information segment and downstream in claims and recoveries; it is seeking national and international alliances with a view of becoming the fourth world player in the short term credit insurance business.

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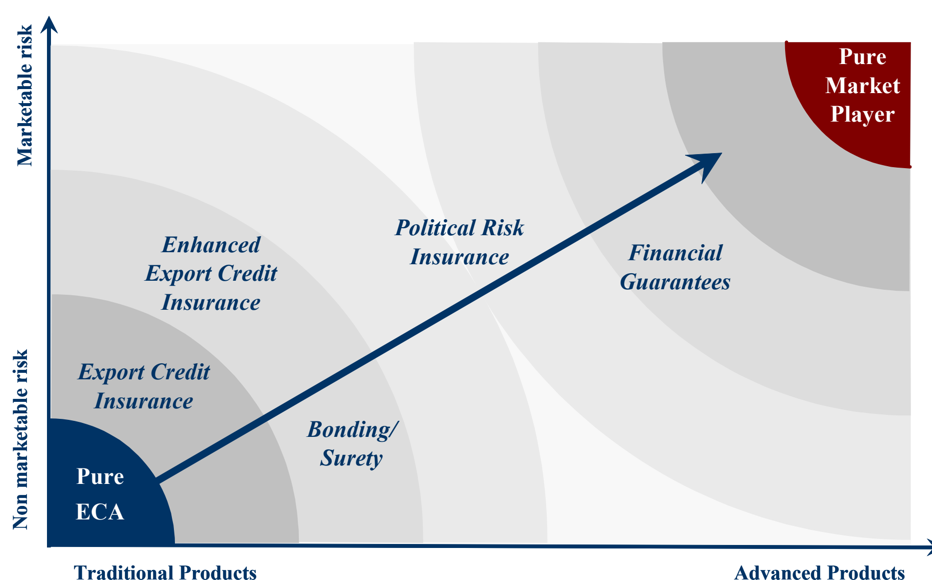
[4] The fact that SMEs can be penalized in the access to private credit insurance has been later recognized by the European Union which has amended its rules and regulations to allow ECAs, at certain conditions, to offer export credit insurance in the short term segment.

Fig. 4 - Becoming a quasi market player: new products and new markets



At the same time, the situation and strategy of SACE SpA is also changing. In 2004 when it was transformed in a Joint Sock Company, SACE had a capital endowment of 7.3 billion Euro. In the following two years it has generated high profits thanks to high recoveries from Paris Club debt, negligible claims and a good premium level. This framework has created the possibility for the company to return, in the beginning of 2007, 3.5 billion Euro of capital to its shareholder, the Ministry of Economy and Finance without any impact on its rating (Moody's: Aa2). The reduction in its capital is, on the one hand, the result of the fact that the Italian State continues to support SACE SpA's business through its counter-guarantee but, on the other, also of the fact that its "stand alone" rating remains solid, thanks to both the improved quality of its capital (now invested in high rating liquid assets) and its underwriting (claims in 2006 where less than 20 million Euro). The remaining economic capital is still very ample to which must be added almost 2 billion Euro of technical and other reserves, and it is fully coherent with the development strategy of the Group.

6. Final remarks and open issues

The changes in the global economic and financial environment and the increasing role of the private sector in the economy are among the factors triggering a change in the export credit insurance business model. At the same time, the volatility that affects global markets call for the preservation of an insurer of last resort that can also support difficult transactions that the market alone can not undertake, in a world where the historical divide between marketable and non-marketable risks becomes foggy. The private player and the public agent can provide depth to financial markets by working in partnership. In some instances and segments, ECAs can also enhance competition by offering an alternative to rent seeking behaviours. The view is that there is still a role to be played by ECAs, although not the same as in the past nor through the old business model. This being said, the changes needed to be introduced may be so profound that the concept itself of Export Credit Agency can be put in question: the new subject may neither limit itself just to export nor to credit, and may no longer need to be under public control.

The ECA business can no longer by justified in terms of traditional market failures: not that they have disappeared, simply they can take different forms at different times. Like many other public players (i.e International Financial Institutions), ECAs can choose between losing their role and become increasingly marginal or changing into something different, a *quasi-market player*, i.e. a player that still has a public mission that it would carry out through the adoption of a private player's approach driven by the search for efficiency, customer satisfaction and, why not, even a positive profit. This player would work simultaneously on marketable and non-marketable countries, sectors and transactions; its public backing allowing it to take greater risks but with a view of not losing out financially but rather breaking-even or even making a profit.

Today such a strategy appears viable in the light of the improved ECA fundamentals; better distribution and management of risks; improved outlook for many key markets; superior technical capacities within ECAs; and greater accountability and transparency of the financials. All these new features point in the direction of a new model. Whether this model can successfully be sustained over time it is hard to say: today the international outlook is bright, but it will be tested sooner or later, and only then will it be clear what the real challenges are, and we will know the answer. For now, the only choice available is between wanting to take up the challenge or going down the slow path towards irrelevance.

While challenging and rich in of opportunities, the transformation envisaged in this paper is not without risks. The adoption of a *quasi-market player* model for the export credit and export finance insurance business opens a series of questions for which further investigation is deserved:

- The old divide between marketable and non marketable is becoming less and less relevant. Since most ECAs still perform some public functions and are linked to the State (either because the government is a shareholder, or because they enjoy some form of even indirect government capital guarantee) it may not be clear cut to distinguish when they are operating as a government agent and when they are competing on a level playing field with the private sector. Is an ex-post assessment of their behaviour sufficient to make sure that ECAs play by the market rules? Can the transparency and auditing of its financials be sufficient to judge whether they abide to market rules? Given the fact that the new player will be operating on both marketable and non-marketable transactions, to what extent can we derogate from the principle of profit maximization in judging its performance? What regulatory and governance instruments are needed to facilitate this monitoring?

- <u>The traditional argument in favour of government intervention in the export credit insurance business rests on the nature of social benefit provided by the service.</u> While this principle is weakened in some of its assumptions, market imperfections may still be important even when political risks decline and commercial risks that can be insured by private sector agents prevail. These imperfections have to do with asymmetric information between agents and can lead to moral hazard and adverse selection and inefficient outcomes for the insurance market, especially when the risks are cross border, difficult to asses, of long maturity and high potential losses. As we have illustrated in the previous sections, the more traditional ECA business is not insurable according to classical market tests. How important are these market failures today? Do they represent an argument in favour of continued ECA intervention?

- As emerging markets become more important for the global economy, financial systems get deeper and more diversified. This should lead to less volatility and better risk management. On the contrary, the opposite has occurred and <u>in recent decades financial crises have been frequent, including in countries with strong macroeconomic fundamentals</u>. A more integrated economy may be more difficult to manage and keep stable if abundant liquidity on the capital markets reduces the scope and influence of global financial institutions. In this context crisis risks may not be adequately captured by capital markets and the risk pricing may be underestimated for some events and their consequences. What are the implications for export credit insurance? Is there any role for a quasi-market player in credit enhancing to counter-cyclicality of lending during serious downturns? Is this an appropriate role for export credit insurance companies or should it be left to IFIs?

- <u>The transition from insurer of last resort to quasi-market player may just be the initial step in a longer process</u>. But where does this process end? Should the transformation of export credit insurance companies into full-fledged private

insurers competing in all sectors and markets with other private companies go all the way? What would distinguish then an ECA from a private player? Or, in the opposite vein, will the new player in the face of the first crisis and ensuing large defaults loose its independence and revert back to a strictly controlled public agent? If the transition can not go all the way, where is the likely boundary? How can the balance between being a government-supported body and playing by market rules be maintained over time?

- Political economy arguments are also important in shaping the transformation of export credit agencies into quasi-market players. The transformation that we are envisaging will have domestic winners and losers with different weights and political clouts. National interests might become less protected from a quasi-market player more attentive to the quality of the risks underwritten, the price charged, the balancing of its portfolio. Certainly less than back in the old days when the economic rationale of export and employment support was paramount. More often too risky transactions will be turned down; pricing will have to be made more in tune with the underlying risk; other financial players may find themselves in competition on some transactions. How are these factors going to shape the pace and the result of the transition from traditional to modern export credit and export finance insurance in different systems?

In summary, the debate on what role should be played by ECAs is still a very open one. On the one hand, such a role has probably today a smaller macroeconomic impact than that sought or achieved in the past, even for countries that have developed it the most in order to cover a large share of national export. On the other hand, it is still a key public tool that makes possible transactions that would not have otherwise occurred. As the segments and markets of their involvement are always changing, ECAs must be prepared to change themselves and the forms of their support: in the nineties their historical business (sovereign risk insurance) has almost

disappeared, and they have been able to enter into entirely new transactions such as large structured and project finance deals. Much of the energy projects under development today, so crucial for international stability and growth, would not have been possible without ECA involvement. ECAs have supported East Asian countries after the crisis of the end of the century and have provided credit to sectors like telecommunications and steel when private lenders where withdrawing because of excess exposure. They are the preferred if not sole tool to support countries that emerge from prolonged crises or even political instability, in an effort to help create the conditions for a sustainable development. In many industrialized as well as emerging countries, the access to export credit by the smallest companies is clearly inadequate (a market failure) and is now becoming a top priority for ECAs. Other countries have small or too domestic-oriented financial sectors, and ECAs are instrumental in supporting the offer of financial products for their companies or relieving banks from excess risk concentration on their balance sheets at a time of the introduction of new accounting standards and financial regulations. How all this will further evolve is hard to predict, but this is an interesting story nonetheless, with unique national experiences around the world that, unfortunately, are not adequately known outside the ECAs world.

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