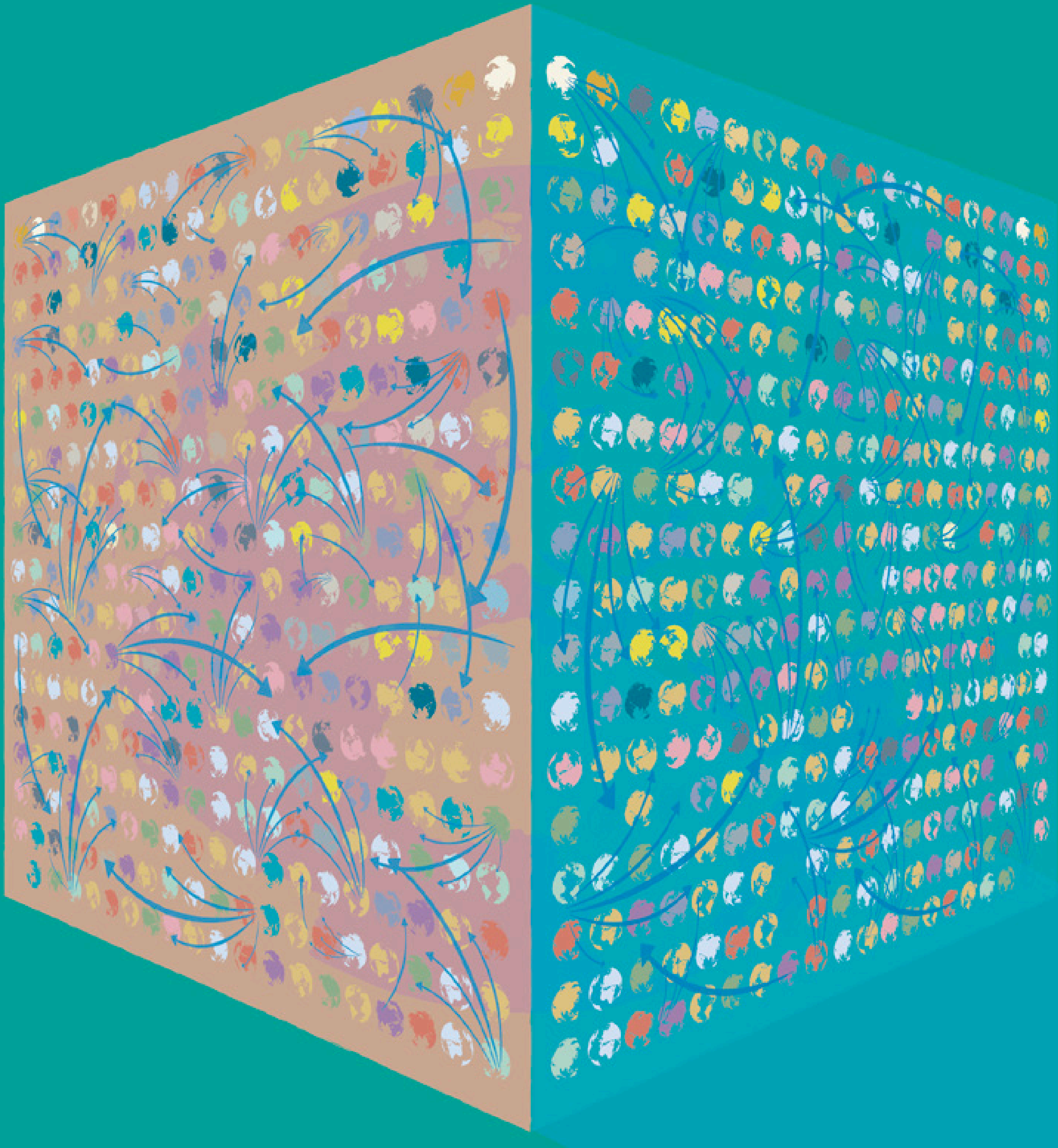
# berneunion



# YEARBOOK

2016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# 1

# Introduction

# The Berne Union: Who's Who 2016

## Berne Union Elected Officials

**President, Topi Vesteri**
FINNVERA Finland | Deputy CEO, Group Chief Credit Officer

Topi Vesteri joined Finnvera in 1998 as executive vice president responsible for running Finland's officially supported export credit and guarantee system. Having managed Finland's state backed ECA business for almost 17 years, Topi assumed the position of deputy CEO and group chief credit officer responsible for credit and analysis functions of both export credit agency (ECA) as well as domestic SME financing business of Finnvera, in October 2015.

Topi is chairman of the board of Finnish Export Credit Ltd, the subsidiary of Finnvera responsible for providing funded export credit solutions and chairs also the boards of Finnvera's venture capital subsidiaries Veraventure Ltd, Seed Fund Vera Ltd and ERDF Start Fund Ltd. Topi also served as board member of Finnish Fund for Industrial Cooperation Ltd (Finnfund), Finland's official development finance agency and as a board member of Finnish Credit Insurance Ltd.

Before joining Finnvera, Topi had a 17-year banking career in Postipankki, one of Finland's leading commercial banks. During this period he held various managerial positions in Helsinki, Tokyo and London covering debt capital markets, corporate banking, leasing, international network and lending as well as general management of the bank's overseas and domestic subsidiaries and business units.

Within the Berne Union, Topi was appointed president in 2015, was chairman of the Medium and Long Term (MLT) Committee in 2009 – 2011 as well as Vice President of the Union in 2003 – 2004.

Topi holds a Master's Degree in Law (LL.M.) from the University of Helsinki.

**Vice President, Michal Ron**
SACE Italy | Managing Director, Head of International Relations and Network

With extensive experience in the world of structured finance and export credit, Michal Ron is currently managing director, head of international business in SACE, overseeing the group's international relations, overseas network and political credit recovery.

Her responsibilities include all activities related to the Paris Club and other political recoveries, with a track history of €10 billion in sovereign recoveries over the past years and the achievement of successful results in post-sanctions contexts such as Argentina, Cuba and Iran, paving the way for these countries to regain access to international markets.

Over the past seven years, Michal has steered the expansion of SACE's overseas network, supervising international underwriting generated by the 10 offices abroad (Bucharest, Dubai, Istanbul, Hong Kong, Johannesburg, Mexico City, Moscow, Mumbai, Nairobi, Sao Paulo). She also manages SACE's role within the OECD and EU, Reinsurance Agreements and the overall relationship with other export credit agencies.

In 2014 she has been elected to the role of vice president of the Berne Union, and reconfirmed in the same position in October 2015. In her capacity as Berne Union Vice President she has led numerous initiatives, including the Outreach Working Group between the Berne Union and the World Bank.

Prior to working at SACE, she spent 10 years at MCC SpA (head of oil, gas and petrochemicals, structured finance) and sevem years with HSBC (London, Madrid, Milan).

With a Business Studies, Risk Management and Finance BSc Honours degree from City University Business School (London), Michal has worked in investment banking in several European countries and has been invited to speak in numerous business conferences worldwide.

She is based in Rome, Italy (SACE's headquarters).

## Short Term Committee

**ST Committee Chair, Verena Utzinger**
SERV Switzerland | Senior Relationship Manager

Verena Utzinger has been working for Swiss Export Risk Insurance 'SERV' since Spring 2000. Initially she joined the underwriting department, with responsibility for key accounts, financial and various other institutions in French-speaking Switzerland, as well as Ticino and a part of German-speaking Switzerland.

Verena is now responsible for relationships with financial institutions, new customers and bilateral chambers of commerce, as well as coordinating collaboration with the private insurance market within the framework of reinsurance agreements.

Verena is a member of the board of SABC Swiss African Business Council in Switzerland.

As the head of the Swiss delegation at the Berne Union, she represents SERV at various Berne Union meetings and also appears regularly as a speaker at other external events.

**ST Committee Vice Chair, Chunyi Xiao**
SINOSURE China | Deputy General Manager of Export Trade Credit Underwriting Department

Ms. Xiao Chunyi, deputy GM of ST Export Trade Credit Underwring Dept, in charge of large credit approval. She has been working in Sinosure since its establishment in 2001.

## Medium / Long Term Committee

**MLT Committee Chair, Beatriz Reguero**
CESCE Spain | Chief Operating Officer

Beatriz Reguero joined CESCE, the Spanish Export Credit Agency (ECA) in 1999 as deputy director of the country risk and international relations department. In 2012, she became the COO (chief operating officer) of the State Account Business at CESCE. Between 1992 and 1999 she held different positions in the Spanish Public Administration, mainly within the Ministry of Economy, related to Trade responsibilities.

Within the Berne Union, she was appointed chair of the Short Term Committee for the period 2010 – 2012.

Beatriz graduated in Economics from the University of Madrid in 1989.

**MLT Committee Vice Chair, Adi Gross**
ASHR'A Israel | Chief Underwriting Officer

Adi Gross is ASHRA's (the Israeli Export Credit Agency) chief underwriting officer. He first joined the company as an underwriter in 1999 and following his return in 2009 now leads the underwriting teams, with overall responsible for the company's credit insurance process, reinsurance, IT system and customer service.

Within the Berne Union, he was appointed for vice chair of the Medium and Long Term Committee in 2015, and was the chairman and the host of the first Berne Union Reinsurance Specialist Meeting held in Tel Aviv, Israel in the same year.

Previously, Adi worked from 2007-2009 for ZURICH Surety Credit and Political Risks as a consultant for business development and marketing in CIS and CEE countries.

He holds an MBA from Tel Aviv University, Israel, majoring in Finance and Accounting and a BA in Economics from Ben-Gurion University, Israel.

## Investment Insurance Committee

**INV Committee Chair, Vinco David**
ATRADIUS DUTCH STATE BUSINESS
Netherlands | Senior Manager

Vinco David has 30 years' international experience in credit and investment insurance.

He is currently a member of the management team of Atradius Dutch State Business NV, the Export Credit Agency of the Netherlands. His responsibilities include international relations, reinsurance, product development, market development, communication and corporate responsibility.

Previously Vinco David held positions at the Berne Union Secretariat and the Netherlands Ministry of Finance. He holds an MA in political science and international relations and a BA in economics and Italian language and literature from the Free Reformed University of Amsterdam.

**INV Committee Vice Chair, Christina Westholm-Schroder**
SOVEREIGN RISK INSURANCE Bermuda | Chief Underwriter

Christina is responsible for all aspects of Sovereign's transactional underwriting, with particular focus on capital markets and financial institution business. Christina is also relationship manager for a number of Sovereign's ECA and Multilateral Agency clients. Christina has worked in the political risk field for more than 30 years. Prior to joining Sovereign, she was with the Multilateral Investment Guarantee Agency (MIGA) for 11 years.

She joined MIGA as one of its first employees in 1988 and worked in several capacities, including regional manager for Asia and Latin America and most recently as manager for syndications and business development. In this capacity, she was also responsible for the Agency's re- and co-insurance activities.

Prior to MIGA, Christina worked as a political risk insurance broker in the Bank of America's global trade finance department in New York and as manager in the political risk department at AB Max Matthiessen in Stockholm, Sweden. Christina has an MBA in international business from Stockholm School of Economics and Business Administration and an MBA in finance from New York University.

## Prague Club Committee

**PC Committee Chair, Chris Chapman**
NZECO New Zealand | Head of New Zealand Export Credit Office

Chris joined New Zealand export credit agency 10 years ago, when it was in its formative stage, and has supported NZECO's growth both in terms of an expanded product range, as well as increased exports and exporters supported. Chris has previously practiced law in New Zealand and holds a Masters in International Business, as well as a law degree, from the University of Otago.

## Berne Union Secretariat

**Kai Preugschat**
Berne Union | Secretary General

Kai joined the Berne Union – the International Union of Credit & Investment Insurers – as the organisation's Secretary General in August 2014, based in London.

Until then, Kai was UniCredit group's deputy global head of export finance. He also chaired the ICC's steering committee for its medium / long term Trade Register and serves as independent member on the board of SME export financier Northstar Trade Finance Inc., Canada.

Previously Kai co-headed the underwriting and risk management division of Germany's Official Export Credit Agency, Euler Hermes. Before joining Euler Hermes, he managed the Export Finance Bank-project "EFB" in Singapore, sponsored by ANZ Banking Group. EFB advised on and arranged ECA-guaranteed loan facilities.

From 2004 to 2008 Kai was responsible for the establishing and management of KfW IPEX-Bank's Financial Products Advisory department, providing the bank's industry divisions with specialist advisory services for credit risk insurance, financial modelling as well as trade- and LBO-finance. On behalf of KfW IPEX-Bank, Kai also served as deputy advisor to the German highest decision making body for export credit guarantees, the Inter-Ministerial Committee.

During 1986 and 2004 Kai held various managerial roles for ANZ, Bayerische Landesbank and Hypo-Bank with assignments in Germany, Asia and Australia, focusing on export, trade and project finance. In Sydney Kai also worked for Australia's ECA EFIC.

**Laszlo Varnai**
Berne Union | Associate Director (ST Committee Support)

Laszlo joined the Secretariat in June 2016, mainly to advise it on legal matters and to support the Committees (primarily the ST Committee) and Specialist Meetings. He gained focused experience in policy analysis as he worked for EXIM Hungary for more than 5 years, leading the ECA's international relations (OECD, EU and Berne Union) and ensuring compliance with WTO, OECD and EU regulations, as well as the international sanctions.

Laszlo graduated in law from Peter Pazmany University, holds a DipHE in Law of England and Wales and the European Union from the University of Cambridge, and diploma of economic diplomacy from the Károli Gáspár University in Hungary.

**Johannes Schmidt**
Berne Union | Associate Director (INV Committee Support)

Johannes joined the Secretariat in April 2016. He is responsible for supporting the chair and vice chair of the INV Committee as well as its members (public, private and multilateral insurers) with regards to their membership. In his role Johannes is also supporting the INV Technical Panel, a subcommittee where technical underwriting issues are discussed amongst INV Committee members.

Before joining the Berne Union, Johannes was an underwriter in political risk insurance and untied loans for Berne Union member PWC, managing the German Government's Investment Insurance and Untied Loan Guarantee Programmes.

Johannes holds a Masters Degree in International Business of Macquarie University Sydney and a Diploma degree in Economics at the University of Ulm.

**Laura Lind**
Berne Union | Committee Support Manager (MLT Committee)

Laura Lind joined the Secretariat in December 2015. Her main responsibility is supporting the Medium Long-Term Committee and all related activities, including cooperation with the ICC Banking Commission.

Prior to joining the Secretariat, Laura completed her Master´s Degree in International Relations and European-Asian Studies, complementing her Bachelor´s degree in Business Administration.

Laura previously supported Finnvera´s export finance and international relations departments after working for five years as programme assistant with the Finnish Fund for Industrial Cooperation Ltd. (FINNFUND).

**Ella Szukielowicz-Lindon**
Berne Union | Committee Support Manager (PC Committee)

Ella joined the Secretariat in November 2014 as business support manager, heavily involved in operational duties but currently looking after Prague Club Committee and its members. Ella has broad knowledge and experience in financial sector and previously worked as human resources manager in a private equity firm. Ella holds a B.Sc. in Business Administration and Economics.

**Massimo Sarti**
Berne Union | Data Manager

Massimo joined the Secretariat in January 2015 as data manager, with responsibility for the data transformation project and for handling data collection from the Members as well as reporting.

Previously Massimo worked at Italy's SACE for eleven years as senior IT manager in the IT department. He has a long professional history and extensive experience in project management and IT services, gained also in health care, consultancy and technological sectors.

**Paul Heaney**
Berne Union | Media & Communications Manager

Paul joined the Secretariat in July 2016 as the first ever media and communications specialist, with responsibility for handling internal and external communications. Paul's objective is to increase engagement amongst members within the BU, as well as expanding on our outreach and collaboration with external institutions trade press and media.

Prior to joining the BU Paul worked as a conference producer at Informa, running the ExCred (Insuring Export Credit & Political Risk) series of events.

Paul holds a BA in Philosophy from Trinity College Dublin and an MA from King's College London.

**Nicole Cherry**
Berne Union | Team Assistant

Nicole joined the Secretariat in July 2016. Nicole provides assistance to the Secretariat Team and manages the office. She has recently moved back to the UK after living in Tanzania for six years working with NGO's and running a volunteer organisation. Most recently she worked as the personal assistant for the CEO of the largest company in East Africa, MeTL.

**Dong Hyuk Kim**
Berne Union | Data Secondee

Dong-hyuk is joining the Secretariat until the end of 2016 on secondment from KSURE. His primary areas of work will be the management of Berne Union business data, including managing the collection and reporting of such data from Berne Union members.

Dong-Hyuk has more than 10 years export credit experience working for KSURE, most recently he served as a manager of audit department in KSURE. Dong-hyuk holds a BA in Law from Sungkyunkwan University.

## Management Committee Members

| | | | |
|---|---|---|---|
| ATRADIUS | COFACE | ECGC | ECIC SA |
| EULER HERMES | EXIMBANKA SR | SERV | SINOSURE |
| SOVEREIGN | UKEF | US EXIMBANK | ZURICH |

INTRODUCTION

# 2016: a leap-year, year of change and year of growth for the Berne Union

**Topi Vesteri, Berne Union president, and deputy CEO, and group chief credit officer of Finnvera, reveals how the Berne Union continues to support a growing amount of global trade, and reports on the importance of the formal merger with the Prague Club.**

2016 has been an eventful, and in some respects surprising year so far. A number of high-profile political developments – not least the UK's referendum to exit the European Union – sit against a backdrop of difficult economic conditions, rising geopolitical risks and uncertain financial markets. Collectively, these trends have sustained the challenging environment for trade we saw in 2015.

Figures from the World Trade Organisation (WTO) indicate that world trade experienced a considerable decline in 2015, down over 13% on 2014 to just under $16.5 trillion. Low energy and commodity prices and very cautious low investment activity certainly account for a significant portion of this, but also changing patterns of demand and currency fluctuations.

In line with these developments in the wider global economy, Berne Union members have also recorded a decline in volumes of export credit insurance – collectively underwriting around $1.84 trillion of new business in 2015. However, it is noteworthy that this drop – down approximately 7% from 2014 volumes – is considerably lower than the comparable fall in overall world trade, and in actual fact, the percentage of global trade supported by Berne Union members continued to rise, amounting to over 11% for 2015 business.

Topi Vesteri

This statistic underlines the important role which Berne Union members play in facilitating trade in difficult economic environments, as well as the counter-cyclical and stabilising function of the credit insurance products they provide. Of course this stabilising role can only be effective where the industry is confident that Berne Union members' credit insurance and investment insurance products perform both in good times and in bad. In respect of claims, Berne Union members paid out $5.9 billion in 2015 – a 38% increase when compared to the $4.3 billion recorded in 2014.

Indeed, since the beginning of the global financial crisis in 2008, Berne Union members have paid approximately $35 billion to exporters and banks to compensate them for losses suffered due to defaults by buyers or other obligors, thus Berne Union members have provided ample and flexible risk capacity to support international trade transactions and to foster sustainable economic growth.

**2016 has been an eventful, and in some respects surprising year so far. A number of high-profile political developments – not least the UK's referendum to exit the European Union – sit against a backdrop of difficult economic conditions, rising geopolitical risks and uncertain financial markets.**

## Significant changes for the Berne Union in 2016

An affirmative vote at the May 2016 Spring meeting in Warsaw confirmed the formal integration of the Berne Union and Prague Club, bringing combined membership to a record 82 companies from 73 countries, representing over 90% of world population.

The Berne Union has always been an international organisation, with global interests, but this development is significant in bringing together a wider cross-section of industry representatives than ever before. Our members include the largest private credit insurers and most ambitious government-backed ECAs, with global footprints, writing business in excess of $400 billion, as well as small regional outfits, with annual turnover of only several million US dollars, and everything in-between.

It goes without saying that a larger number of members, writing more business can only be a good thing for the representation of the collective organisation; but even more so, for an industry which resists a cookie-cutter approach, this diversity of representation is itself both important and appropriate, and the resulting exchange of information is invaluable to all members and the wider trade finance community.

These themes of engagement, diversity of representation and communication exchange are central to the Berne Union's vision, and have informed the continuing evolution of the organisation as we adapt in line with both our members and the changing landscape we all find ourselves in.

We are currently poised to initiate the next steps in reform of the Berne Union Management Committee, incorporating representation for our colleagues at the erstwhile Prague Club – which now sits as a specialist committee, alongside those for Short-Term, Medium/Long-Term and Investment Insurance – as well as making changes to the terms served by elected officials, and the rotating members. The intention is that this will facilitate more effective leadership, better overall representation and smoother transitions from term to term.

Execution of long-term strategy will be the remit of newly established Task Forces, initially focused on Data, HR & Finance and Outreach. These will provide a concrete means of delivering the Berne Union's strategic goals, and will allow the Management Committee to more efficiently direct its resources and expertise to this end.

The world of export finance has changed considerably, even just in the eight years since the start of the global financial crisis. The role of ECAs in particular, and providers of export credit in general, has been central to this. Determining how our industry relates to the banks and other financial institutions in the trade space is essential to remaining relevant in such a rapidly changing environment, with complex external drivers.

## Alternative sources of finance and diversification of risk

Regulation remains a primary concern for lenders. The Basel Committee's stringent capital and liquidity requirements in particular has put pressure on banks' capacity to support trade and to a large degree has encouraged trends towards banks as arrangers, seeking to originate to distribute, leaving noticeable market gaps in funding. Small businesses, the potential growth engines of future exports in many countries, have been hit especially hard. In this environment of increasingly onerous compliance, where the cost of providing trade finance facilities is often not worth the margin for banks, alternative sources of finance are essential.

For the part of ECAs, most temporary export credit funding schemes set up since 2009 have become permanent. Direct lending schemes, transfer schemes, securitisation or funding guarantee schemes, all have their place within the toolboxes of many ECAs, but differing rules on eligibility,

**An affirmative vote at the May 2016 Spring meeting in Warsaw confirmed the formal integration of the Berne Union and Prague Club, bringing combined membership to a record 82 companies from 73 countries representing over 90% of world population.**

application, differing credit quality and cost of funds raise questions as to how far we risk disrupting the putative 'level playing field'.

Partnerships between public and private insurers are increasingly common and these provide a unanimously welcome source of excess capacity and greater diversification of risk. However, there remains a question mark around the rightful territory of state-backed insurers, in a soft, competitive and hungry private market. The Berne Union provides a unique forum for bringing together public and private insurers to collectively tackle exactly these sorts of issues.

We operate in a complex and interconnected environment where ECAs are essential for their capacity building, and also expected to be innovative in adapting to changing client needs, but at the same time remaining conscious of the need to avoid crowding out the private market, whether it is banks or insurers. There is clearly a need for all participants to look carefully at how their respective roles can remain complimentary in this environment. With the right kind of dialogue, we create an incredible opportunity to drive innovative change in export finance and in so doing, enhance flows of trade globally.

It is with such objectives in mind that the Berne Union has formed a specialist Working Group, along with colleagues from the ICC Banking Commission's Export Finance Committee, striving to provide a discussion platform to address key issues of common concern between the ECAs and the export finance arranging and lending banks.

The initial meeting of the Working Group in Rome in June 2016 focused on the coordination of a cross-industry response to regulatory challenges. In particular, the group honed in on the Basel III leverage ratio consultation, and the vital role for the Berne Union, and our members in highlighting and demonstrating the importance and reliability of trade credit insurance to banking clients, regulators and policy makers. Similarly, making steps towards the clarification and standardisation of export credit insurance policy wording to avoid regulatory gaps is helpful in developing complimentary ECA and bank product suites.

Some progress has already been made in lobbying around these issues and the European Banking Authority has recommended the consideration of ECA-finance as a special case, in the context of Basel III implementation. There is, of course, much more work to be carried out, but with the Working Group set to continue meeting regularly, several times a year, the most important outcome is the establishment and maintenance of formal industry dialogue.

The market is moving, our members are changing and adapting and so too is the Berne Union as an organisation.

We find ourselves in a world which is rapidly changing. But while the shape and size of our business may vary over time, and from member to member, its essential function remains constant. Even as new markets now open up – for example now with Argentina, Cuba, Iran and Myanmar – geopolitical rifts, sanctions and conflicts narrow the arteries of business elsewhere. In addition, Fintech, disruptive technology and disruptive business models are leveraging advances in digitisation, automation and big data to find new and innovative ways of structuring and integrating physical and financial supply chains – connecting people who can and want to do business together more easily.

**The Berne Union remains an outwardly focused organisation, dedicated to promoting and representing the industry, with the mission to enhance trade and investment flows globally. Our growing membership helps foster a genuinely valuable professional exchange and reinforces and amplifies our collective voice.**

The Berne Union remains an outwardly focused organisation, dedicated to promoting and representing the industry, with the mission to enhance trade and investment flows globally. Our growing membership helps foster a genuinely valuable professional exchange and reinforces and amplifies our collective voice. Through the course of 2017 we expect to find new ways to engage with the community and look forward to further expanding our external links and collaborations. ■

# A new Berne Union

**By Kai Preugschat, secretary general, Berne Union**
**Paul Heaney, communications, Berne Union**

**As of May 2016, members of the Berne Union and Prague Club voted to fully and formally integrate, creating a new global association for export credit and investment insurance, under the single Berne Union banner**

The Berne Union has entered a new epoch! Two years ago, in celebration of our 80th anniversary, we took occasion to reflect upon the history of an organisation which has witnessed, endured, and indeed propagated dramatic change in the landscape of world trade. Tracing the timeline from our foundation by just four members in the early twentieth century, up to the present day, we charted key milestones in the Berne Union's evolution.

One such important milestone, the foundation of the Prague Club in 1993, paved the way for the expansion of membership to include a host of smaller, recently established and maturing providers of export credits. Initially focused on the newly opened markets of Central and Eastern Europe, the Prague Club quickly evolved to represent the interests of emerging ECAs and credit insurers from across the world; in course becoming the de facto 'incubator' for membership of the Berne Union, with the first PC member (Poland's KUKE), joining the BU in 1999.

Over the past 20 years, the Berne Union and Prague Club have operated in parallel and although several companies have followed KUKE to hold membership of both organisations, they have remained distinct, and hence, until now, unable to fully capitalise upon shared and mutually beneficial synergies of knowledge and resources.

Kai Preugschat

Paul Heaney

Following integration, the Berne Union represents 82 members from 73 countries, including both government-backed official export credit agencies (ECAs) and private credit insurers.

There has long been a great diversity amongst the membership of the Berne Union and never more so than now, following integration with the Prague Club. Under the new Berne Union, 69 operators of state-backed export credit accounts are joined with 12 private insurance companies and 4 multilateral agencies from across the world and with annual turnover ranging from as high as

**Following integration, the Berne Union represents 82 members from 73 countries, including both government-backed official export credit agencies (ECAs) and private credit insurers**

$420 billion down to less than $5 million.

In 2015, Berne Union members collectively provided cover of $1.84 trillion, which compares to just $30.85 billion cover provided by PC members (less than 2%).

Of course the differences are not just limited to business turnover, but also in many cases to the underlying character of the transactions. For example, in comparison to that of the larger Berne Union members, Prague Club business is generally associated with smaller, short-term transactions, often providing working capital facilities and predominantly focused on regional (in many cases South-South), rather than inter-continental trade. Prague Club members themselves are smaller organisations, many of whom have considerably less resources available than their Berne Union counterparts.

The significance of full integration of these two groups is that the Berne Union now brings together a broader mix of credit insurers, in support of both larger and smaller export communities, contributing to greater market representation and a closer framework for valuable exchange of knowledge and expertise.

Integration supports the information sharing and development objectives of Prague Club members, allowing them to engage more closely with their BU counterparts and learn from the greater experience that the larger, longer established and better resourced agencies have developed over time.

At the same time, Prague Club members are well positioned to provide knowledge and insight into the finer points of their local and regional markets which is valuable to Berne Union members and their counterparties engaging in relevant business. It is often the case, particularly in frontier markets, that first-hand knowledge of the local customs and business practices is the most expedient way to avoid the most common pitfalls.

Already, engagement is working well and as we head towards the first Annual General Meeting of the new Berne Union, larger and smaller members are working together to tackle key challenges, collaborating in discussions around country risk, KYC and compliance, and the impact/opportunity of disruptive technology in trade finance.

## Developing a closer community for knowledge exchange and a stronger voice for the industry and products globally

As well as the mutual benefits that members of the Berne Union and Prague Club can realise through greater dialogue and cooperation, this combined global representation also facilitates more effective interpretation and application of international frameworks by all parties, and provides the opportunity work together to influence regulators and standard setters who guide the industry.

The eight years since the global financial crisis have been marked in the world of trade finance by capacity and appetite of the banking sector to bring liquidity to the market in the face of increasing regulation and risk aversion. This environment has undoubtedly given new relevance to the ECAs and credit insurers who support the market, but the efficacy of export credit support can only be fully realised if it is allowed to provide a tangible benefit to end clients, in particular banks looking for capital relief under Basel regulations.

In its most recent report on leverage ratio requirements under article 511 of the CRR, the

**The significance of full integration of these two groups is that the Berne Union now brings together a broader mix of credit insurers, in support of both larger and smaller export communities, contributing to greater market representation and a closer framework for valuable exchange of knowledge and expertise**

European Banking Authority (EBA) explicitly recognised the lower risk of ECA-covered transactions, hopefully paving the way for a more favourable treatment for ECA finance, and ultimately, perhaps, export credit insured transactions more generally.

**The focus remains on enabling collaboration amongst members and the industry at large. As this function solidifies, so will the reliance upon the business data collected and analysed by the Berne Union.**

This follows strong advocacy and engagement efforts from across the industry, including not just the Berne Union, but also colleagues at the ICC Banking Commission, EBF and others, and demonstrates the value of a powerful and coherent industry voice in advancing the collective interests of all participants. Integration of the Prague Club furthers this objective and allows the Berne Union to benefit from more effective internal and external communication of issues central to the industry.

**A new Prague Club Committee will complement the existing Berne Union specialist committees, while retaining the unique identity of the Prague Club**

Of course, the Prague Club has always had its own unique interests and a valuable culture of knowledge exchange amongst its members and its original mission, to support members in developing their export credit and investment insurance schemes and facilities remains valuable.

For this reason, a new 'PC Committee' will continue this nurturing objective, sitting alongside the other specialist committees in short-term, medium/long-term and investment, within the auspices of the newly integrated Berne Union. This will allow the Prague Club to retain its unique identity, while providing greater scope for partnerships and knowledge-sharing amongst all members.

**Industry trends at present suggest that greater integration, greater transparency, greater dialogue and greater outreach will be the priorities of the coming years**

The industry continues to change swiftly and looking forward, members of the Berne Union are individually and collectively adapting their strategy and product development to meet the coming challenges.

SMEs have long been on the mind and in the mouths of policy makers and business leaders alike; an essential, valuable and underserved segment, the challenge lies in overcoming the reversed economy of scale inherent in low-value, low-resource transactions which remain equally burdensome to administer. Technology is beginning to change this, and ECAs and insurers are poised to adapt their product suite to capitalise upon this.

Increasing partnership between public and private insurers has also been a hallmark of recent years. The Berne Union continues to evolve in line with this and as the tenor, capacity and risk appetite of private market insurers grows ever closer to their ECA counterparts the industry as a whole benefits from the increased engagement, new ideas and innovation which is brought to the market by all participants.

The Berne Union benefits greatly from the integration of the Prague Club and in the spirit of these wider developments, the opportunity to bring newly amplified voices to the table can only be of benefit to the industry as a whole. ■

**The industry continues to change swiftly and looking forward, members of the Berne Union are individually and collectively adapting their strategy and product development to meet the coming challenges.**

# A strengthened Prague Club

**By Chris Chapman, manager, New Zealand Export Credit Office**

Did you hear the story about the Bulgarian, Botswanan and Belarussian who entered a restaurant in Muscat, Oman? No this isn't the beginning of a joke, or a James Bond movie plot. Instead it is a scenario typical of a Prague Club meeting.

The Prague Club was first established by five newly-created export credit agencies from Central Europe. Its purpose was to help develop these export credit agencies through sharing the lessons and successes amongst enterprises which face similar challenges and opportunities by virtue of their smaller size and/or relative experience.

Now twenty-three years 'young', the five founding members remain along with a further 33 new and maturing export credit agencies, multilateral and private insurers from across Central and Eastern Europe, the Middle East and Africa, Central and Southeast Asia. The diversity of these institutions is represented amongst the four newest members: Russia's EXIAR (joined 2012); Indonesia's LPEI (joined 2015); Armenia's EIAA (joined 2015) and Senegal's SONAC (joined 2015).

Each of these four institutions have differing business models and product variations but they all share in the collective goal of exchanging information, experiences and best practices in the pursuit of facilitating international trade, often in support of SME exporting firms.

EIAA is also a successful example of the Prague Club's openness and focus on supporting organisations as they proceed through their formal establishment and development stage. EIAA joined the Prague Club in 2013 as an "Observer" and several members cooperated with information sharing in support of EIAA's product and policy development, and its formal establishment as the Armenian government's mandated export credit agency.

The provision of short-term trade credit insurance is common across all Prague Club members, and the majority also provide medium to long term export credits as well as political risk investment insurance.

Chris Chapman

During 2015, the Prague Club members collectively insured $31 billion of exports, which is a steady increase over the last three years. This has occurred against the global backdrop of falling commodity prices (including oil) and geopolitical tensions, which have contributed to negative economic growth and weakening of local currencies. These events have significantly impacted on many of the Prague Club's member economies, which provide a mix of new risks and business demand.

Many members' countries are internationally assessed as being relatively higher risk markets, resulting in reduced risk appetite or capacity from external insurers. However the local export credit agencies and regional private and multilateral insurers often have a different perspective and approach to assessing and managing the risks, because they have a closer understanding of the local companies, political environment, and the culture and norms of doing business. It is this rich vein of local knowledge, networks and experience which is a core competency and strength of the Prague Club members.

A buyer's access to credit as well as an exporter's access to pre and post shipment financing are key drivers for facilitating trade throughout these regions, and the Prague Club members' range of solutions are critical enablers for this trade, especially between SMEs. Although the reality for many Prague Club members is low awareness and utilisation of trade credit insurance within their domestic markets, which often do not have a well-developed private sector market for this insurance.

This provides opportunities for members, who are all focused on ways to increase the profile of their agency and educate companies about the benefits of trade credit insurance. For some members this includes factoring services, while others have developed innovations to their trade credit policies to improve their support of low volume and/or start-up SME exporters.

As an example, Croatia's HBOR provides an export receivables insurance product specifically for micro entrepreneurs, family businesses and start-ups who have annual turnover less than $2 million. This programme has a streamlined administrative process and has resulted in increased utilization by small Croatian export businesses.

Prague Club members' reporting show that over half of members are forecasting similar levels of premium for their short-term trade credit insurance for 2016 compared to 2015. Over a third of the remaining members project higher total premiums for this year, primarily due to higher demand. This trend reflects both success in building market awareness, combined with the increased risks and uncertainties as described above.

In regards to medium to long term export credits, half of those members that provide this product have experienced lower demand for it over the last 12 months. Although there are some notable exceptions, including Russia's EXIAR which continues to steadily grow its export customer base and support increasing volumes of trade.

An important service is the payment of claims as they arise. Total claims paid during 2015 by Prague Club members was $284 million, which represented 25% and 8% increases for the short term and medium to long term export credits respectively.

The majority of members are forecasting their potential loss notifications to remain steady over the next six months, although the level of these notifications is higher, relative to 2014 and 2015.

The Government trade policies of many members, from New Zealand to Belarus, are focused on ways to diversify their country's exporters, exports and their international markets. In turn, the members are looking at ways to develop their own new products beyond their core trade credit solutions.

The provision of pre-shipment working capital and bond insurance or guarantees are new and evolving solutions for several members, as they look to diversify their product range. Many members face challenges in negotiating satisfactory policy terms with their domestic banks, as well as obtaining risk sharing when supporting their exporting clients with these products. These are scenarios which the Prague Club members actively share experiences and solutions about, and which more established export credit agencies, operating in markets with banks who are already familiar about their partnering role and benefits, may not face.

For many of the reasons noted above, the Prague Club members can provide an example to other Berne Union members in regards to effective risk assessment and sustainable support of trade within the Eastern and Central Europe, Middle East, Central Asia and African regions.  Many members can correlate an increase in the utilisation of trade credit insurance within their own domestic market from the date of their institution's establishment. Their success in supporting their exporters can also, over time, validate their regional market and risks to a wider pool of insurers.

**Local export credit agencies and regional private and multilateral insurers often have a different perspective... because they have a closer understanding of the local companies, political environment, and the culture and norms of doing business**

However opportunities for this information exchange is two-way, with several Prague Club members closely partnered with Berne Union members for technical support, new product development, reinsurance and formal cooperation arrangements.

With the formalisation of Prague Club's integration as a fourth Committee of the Berne Union, the professional and personal relationships will only strengthen and the scenario described at the beginning may now extend to "did you hear the story about the Latvian, Iranian, Korean and Canadian who entered a restaurant in Lisbon, Portugal?" ■

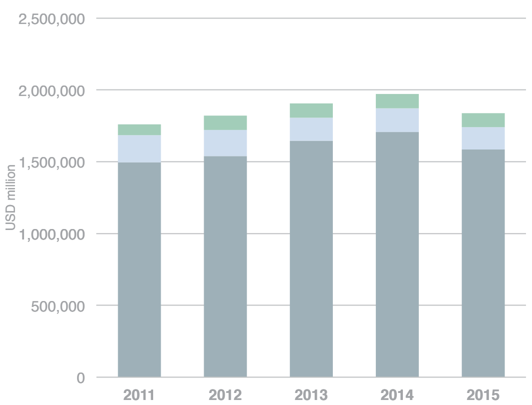
# 2

# Data and Statistics

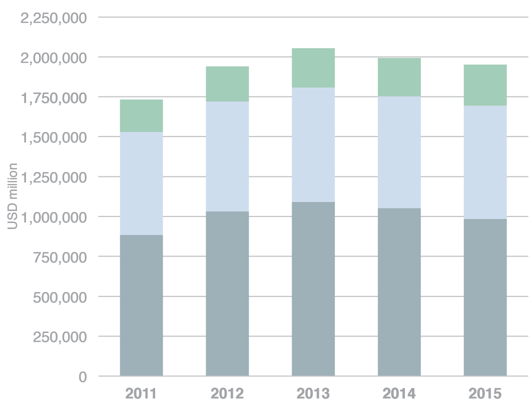
# Berne Union: Totals

**Key**
INV – Investment Insurance
MLT – Medium/Long Term Export Credit Insurance
ST – Short Term Export Credit Insurance

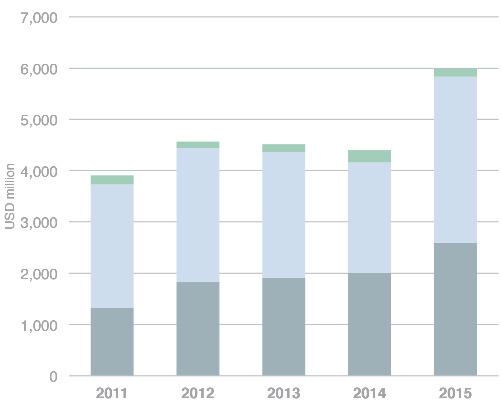
## New Business – during each year



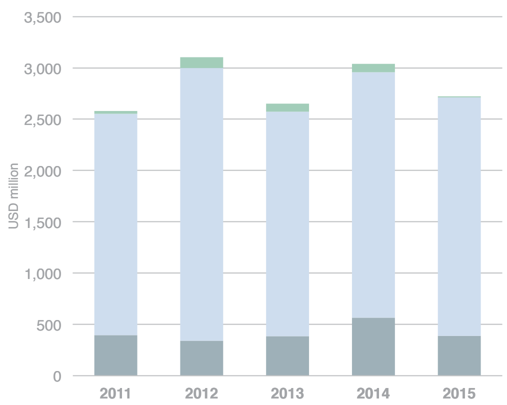

## Exposure – at year end




## Claims Paid – during each year

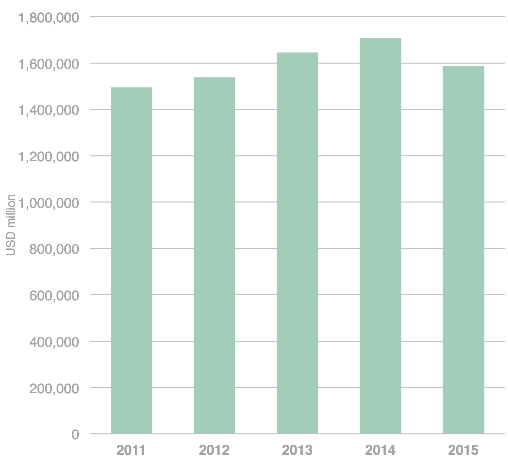



## Recoveries – during each year

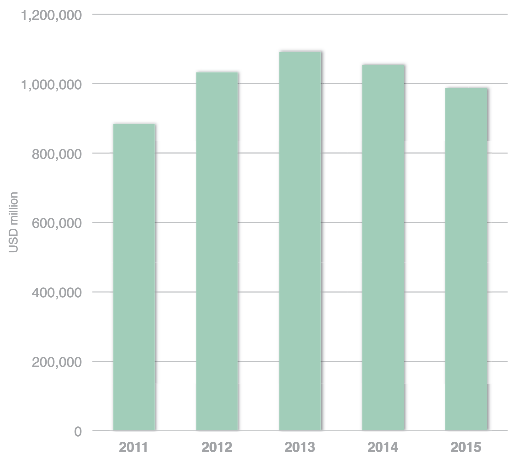



# Berne Union: Short-Term Export Credit Insurance

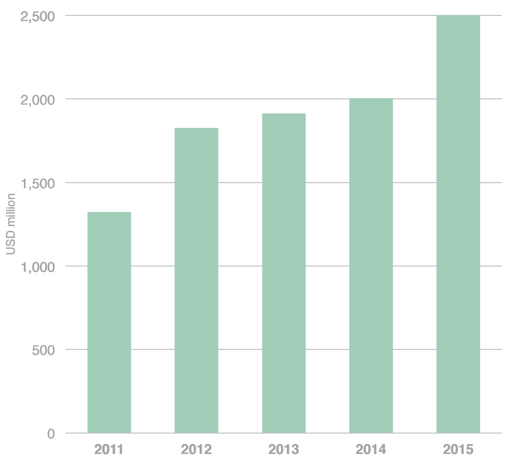
## ST New Business – insured during each year



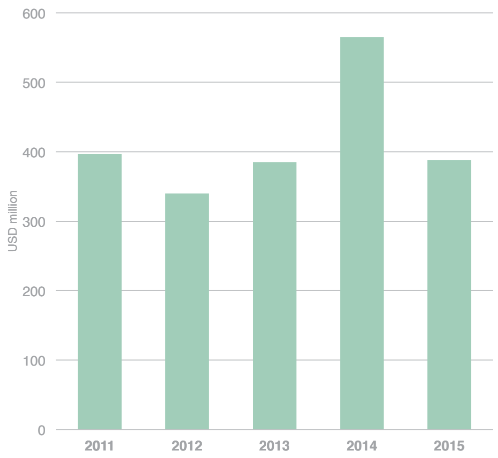

## ST Credit limits – at year end



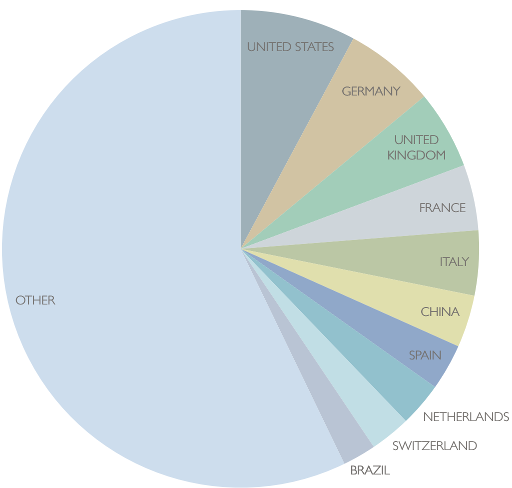
## ST Claims Paid – during each year



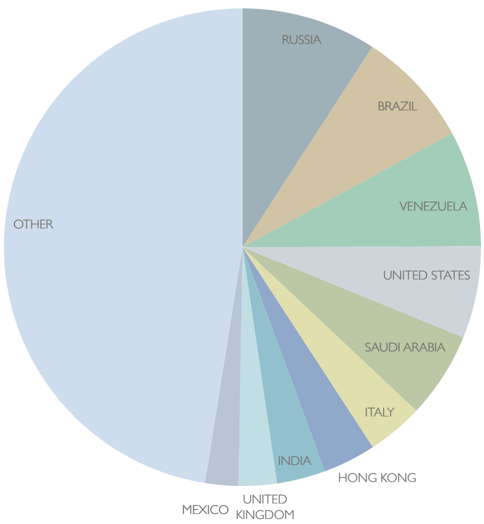

## ST Recoveries – during each year



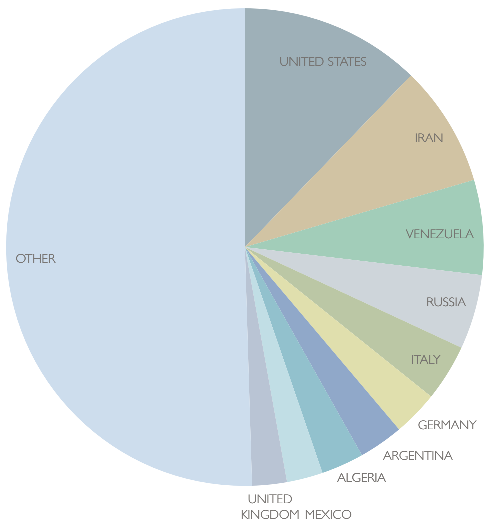

## ST Credit limits 2015: Top 10 countries




## ST Claims Paid 2015: Top 10 countries

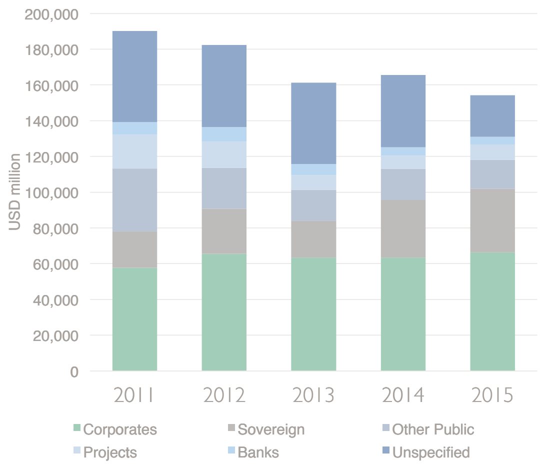



## ST Recoveries 2015: Top 10 countries

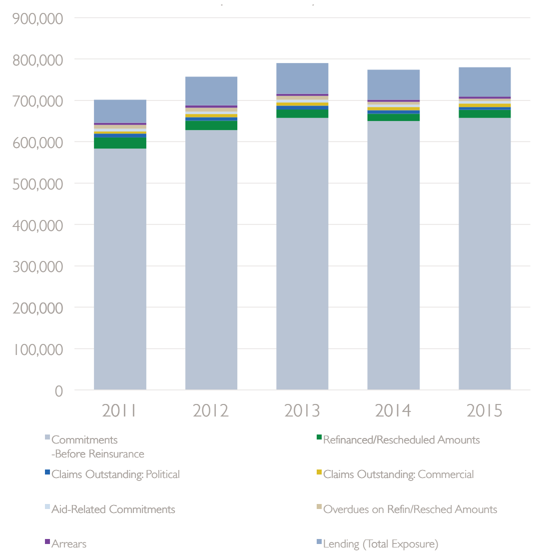


# Berne Union: Medium/Long-Term Export Credit Insurance and Lending

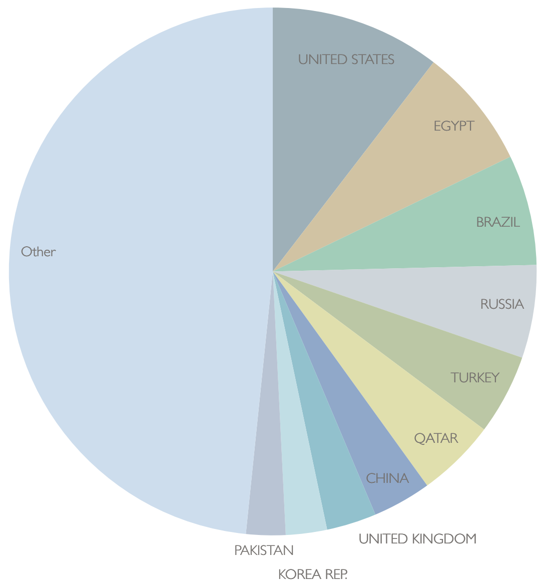
## MLT New Business – insured during each year



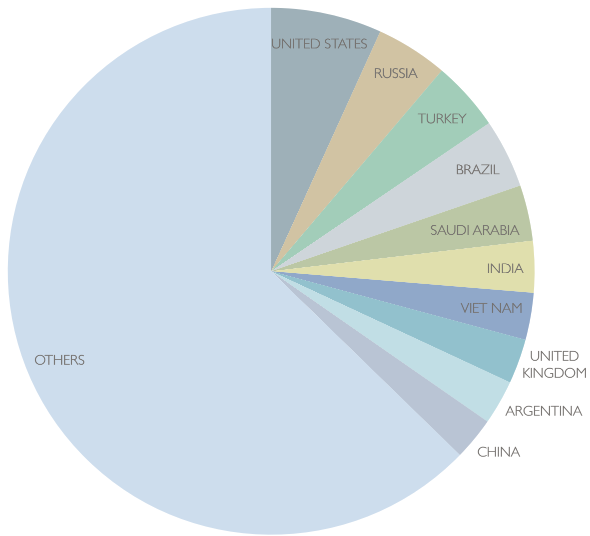

## MLT Exposure – at year end



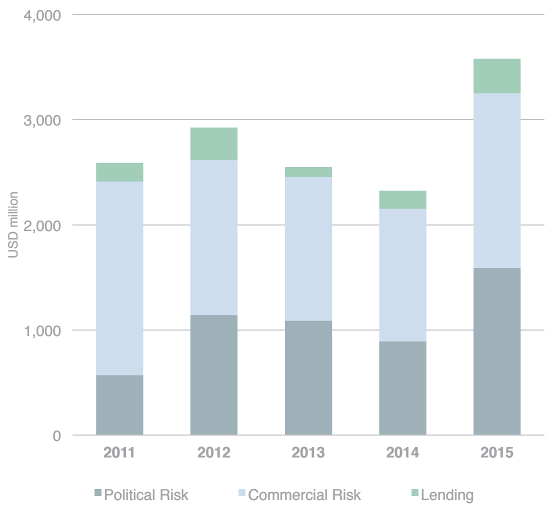

## MLT New Business 2015: Top 10 countries



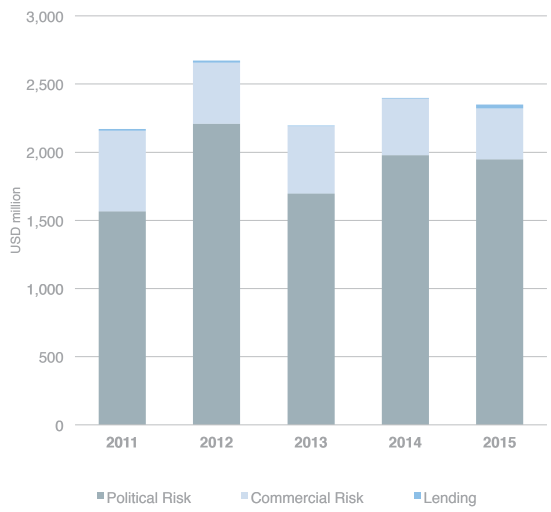

## MLT Exposure 2015: Top 10 countries



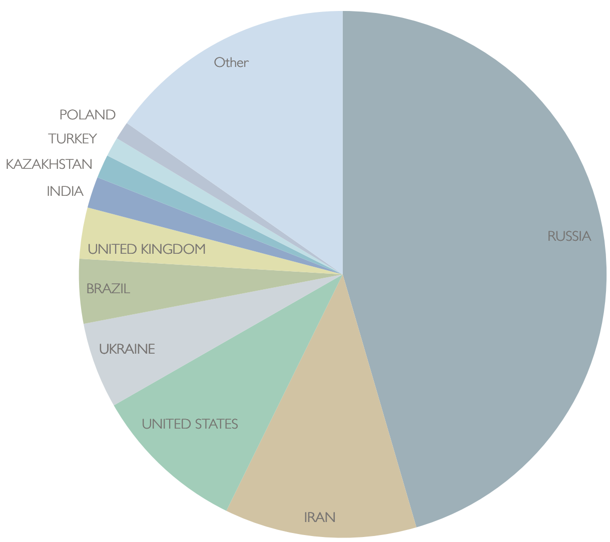
## MLT Claims Paid – during each year



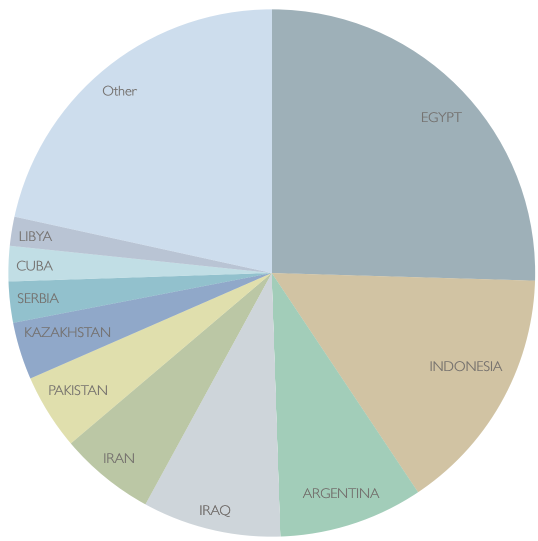

## MLT Recoveries – during each year




## MLT Claims Paid 2015: Top 10 countries

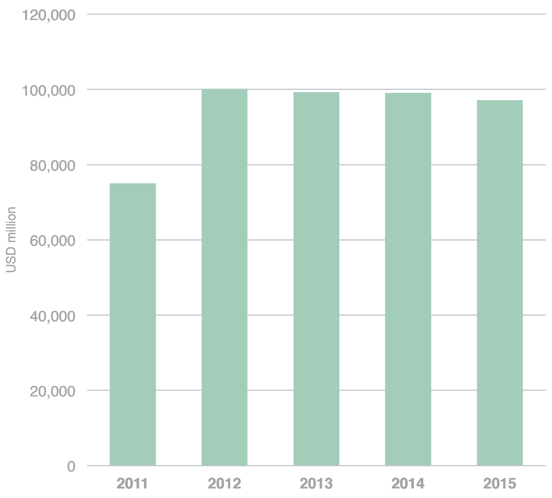



## MLT Recoveries 2015: Top 10 countries

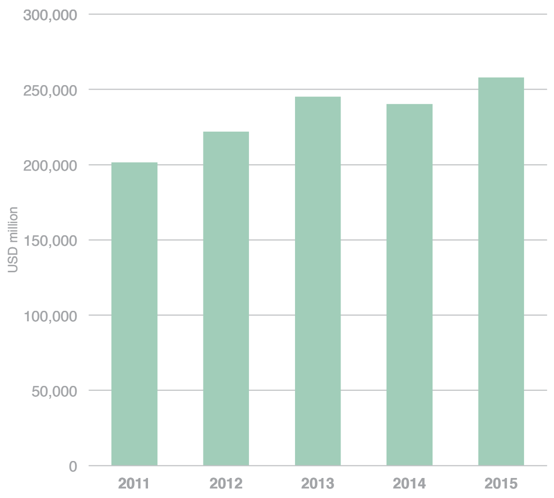


# Berne Union: Investment Insurance

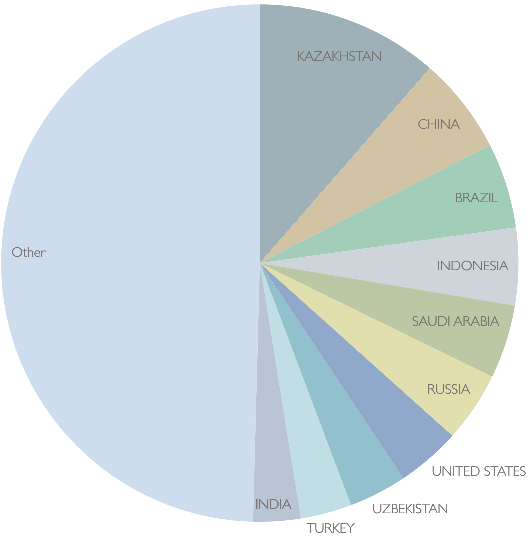
### INV New Business - insured during each year



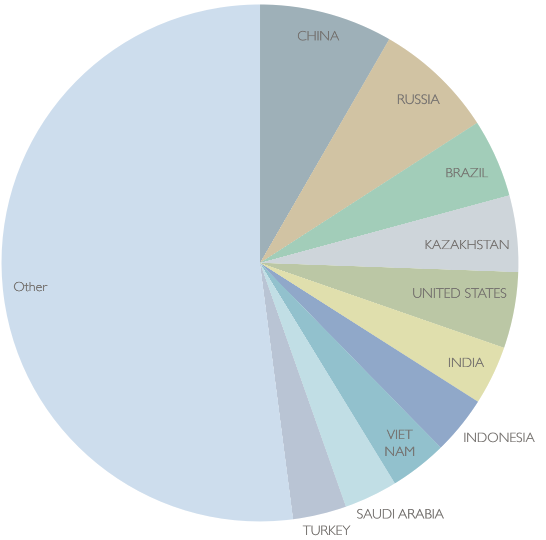

### INV Exposure - at year end



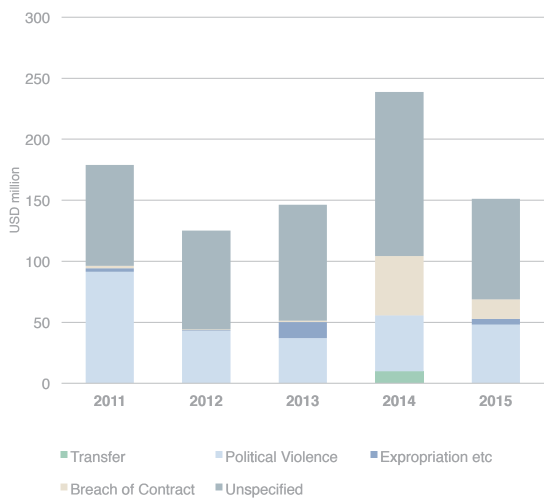

### INV New Business 2015: Top 10 countries



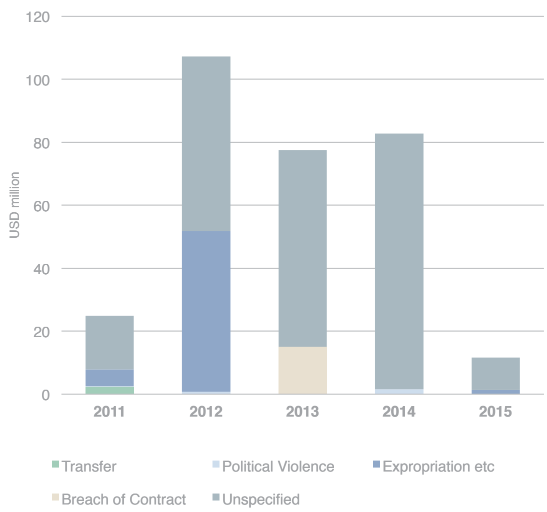

### INV Exposure 2015: Top 10 countries



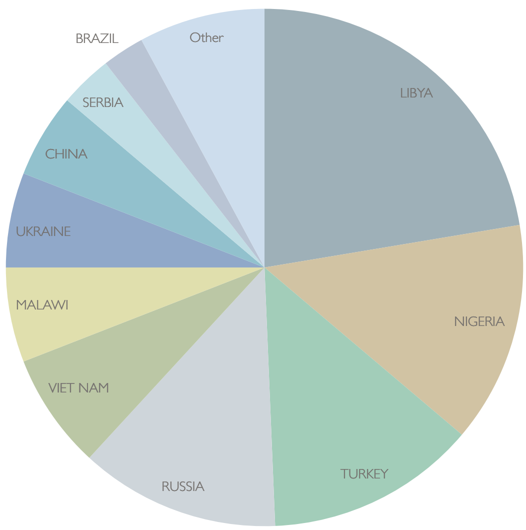
## INV Claims paid – during each year



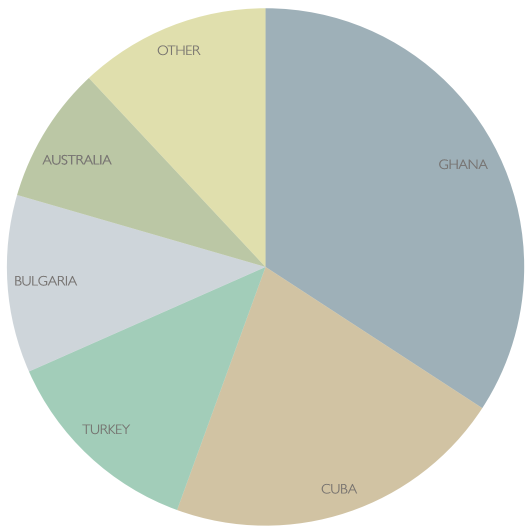

## INV Recoveries – during each year




## INV Claims Paid 2015: Top 10 countries




## INV Recoveries 2015: Top 10 countries



# State of the industry:

## Committee chairs and vice-chairs offer their insights

**By Làszlò Varnai, associate director, Berne Union**

### Reported business trends


Làszlò Varnai

Volumes of export credit and investment insurance reported for 2015 by Members of the Berne Union decreased by 7% to reach a total amount of $1.865 trillion. But Berne Union members still supported about 11% of international trade in 2015.

Within the aggregated new business figures, the value of new export credit insurance cover reported in the Short Term (ST) Committee was $1.586 trillion, the reported value of new cover provided by official export credit agencies ("ECAs") in Medium and Long-Term (MLT) Committee amounted to just over $154 billion, the new business reported within Investment Credit Insurance ("INV") Committee was $97 billion, while the Prague Club Members reported $2 billion new cover issued.

Total claims paid by Berne Union members during 2015 amounted to $6,271 million, an increase of 35% compared to 2014, while recoveries decreased to $2,776 million (-10%).

The Berne Union continues to pursue its initiative to revise the existing data reporting mechanism and to develop it further in order to provide better information to its Members and the stakeholders of the industry, such as international organisations, regulatory bodies and financial institutions.

### Short-term export credit insurance business

Short-term business represents insurance of exports with repayment terms of less than one year – often 30, 60 or 90 days. These transactions are typically shipments of consumer goods and natural resources, with the movements of ST export credit insurance closely linked with the ups and downs of the broader global economic environment and market price levels.

The volume of ST export turnover insured by Berne Union members shrank by 7% in 2015 to $1.586 trillion, breaking the trend since the recovery from the global financial crisis and mainly due to the figures reported by the private Members. The insurance capacity provided by Berne Union members, measured by the value of credit limits approved, just dropped below $1 trillion after three consecutive years, as the aggregated value ($985,045 million) was 6% lower than at 2014 year-end.

ST claims paid by Berne Union members to indemnify exporters for defaults on their trade receivables rose from $2,019 million in 2014 to $2,584 million, which is a drastic 39% increase, but the overall default to turnover ratio of 0.163% continued to reflect sound underwriting practices. Based on the data reported, ST loss ratio (i.e. claims paid as a share of the premiums earned) for Berne Union members continued to increase, now standing at about 70%, after 53% in 2014.

The highest volumes of ST claims paid per country in 2015 resulted from defaults in Russia ($236 million), Brazil ($205 million), Venezuela ($202 million), USA ($161 million), followed by Saudi Arabia ($150 million).

### SHORT TERM COMMITTEE

*Verena Utzinger, Short Term Committee Chair*
*Chunyi Xiao, Short Term Committee Vice Chair*


Verena Utzinger


Chunyi Xiao

The growth rate of global trade has been lower than that of the global economy for five consecutive years ever since 2011, and there seems to be no obvious signal of resurgence in the next half or one year, as the recovery of the global economy is still facing headwinds and uncertainty. Although turbulences in certain markets/regions could create opportunities for credit insurers to a certain extent, a more or less stable trend is expected in short-term business.

In terms of the commodity sector, the presently low trade margins have an influence on the pricing of short-term export credit insurance. The volatile market is expected to remain and the pressure on pricing likewise.

In terms of the commodity sector, the presently low trade margins have an influence on the pricing of short-term export credit insurance. The volatile market is expected to remain and the pressure on pricing likewise.

A key element of success in the future will be innovative product development to meet changing demand arising from various new trade and finance models, e.g. e-commerce companies making their whole trading process (purchasing, logistics, selling, etc.) internet-enabled or fintech solutions that challenge the traditional trade finance world, impacting both financial institutions and insurers.

A close cooperation among Berne Union members will proof to be very valuable to expand and adapt to the needs of the rapidly changing market.

## Medium and long-term export credit insurance business

The MLT statistics of the Berne Union capture export insurance coverage provided by official state-backed ECAs only. Alongside the core insurance business, some ECAs also finance medium and long-term transactions, which amounted to 6.9% of the new business and 9.4% of total exposure reported in 2015.

New business covered in 2015 decreased by 7% (to $154 billion) compared to 2014, although the portion of sovereign and public buyers has significantly increased. The total exposure of ECAs reached $708 billion at the end of 2015, showing a 1.1% increase versus 2014.

Claims paid to customers by ECAs under MLT transactions amounted to $3.251 billion in 2015; an increase by 51% compared to the level of defaults in the previous year, while claims paid for political risks have considerably increased by 78%.

There was no change noted for the top five countries responsible for claims payments, with the highest amounts of claims due to defaults in Russia (1,448 million, Iran ($374 million, halved compared to 2014), USA ($301 million), Brazil ($192 million) and Ukraine ($168 million).

Comparing year-end recovery volumes, 2015 levels decreased by 3% ($2,323 million) on 2014, but comparing half-year figures, 2016 shows a promising trend, with ECAs recovering 74% more claims in the first half of 2016 than in the same period of the previous year ($2,249 million), almost reaching the annual results of 2015 already.

### MEDIUM & LONG TERM INSURANCE

*Beatriz Reguero, Medium & Long Term Committee Chair*
*Adi Gross, Medium & Long Term Committee Vice Chair*


Beatriz Reguero


Adi Gross

2016 will be a momentous year in the Berne Union history: the merging of the Prague Club into the Berne Union at the spring meeting in Warsaw saw the birth of an organization of over 80 members from 73 countries.

While this is certainly a historic event, from the point of view of MLT business, and judging from data and comments as of May, 2016 may well be a transition year when it comes to new business. Total figures for the year 2015 were already below previous years' levels, and we saw in May, an almost even split between ECAs who were reporting a drop in new business and pipeline and those who were seeing an increase. Amongst the reasons explaining the decrease, we can mention the drop in oil prices, the situation in Brazil, Russia and other regions where growth prospects have been revised downwards, a reduction of large-scale export contracts, etc. All of the reason which explain the downturn in business for 2015. We need to keep in mind, however, that ECAs were coming from exceptionally high levels of activity during the years since the global financial crisis, and that one of the traditionally largest player, US Exim, had its own 'domestic' challenges during a part of 2015.

The impact of the downturn can also be seen in what looks like a reversal of a long series of years with very limited and manageable levels of claims. While overall figures are still relatively low compared to exposure levels, 2015 saw a sharp increase in claims, both commercial and political in nature; an increase which we may see prolonged into 2016.

Despite this somewhat gloomy picture, as the new MLT Committee Chair and Vice Chair, our focus at the meetings so far has been to increase the level of members' engagement and to add some new initiatives alongside the regular agenda. Our first opportunity was in Warsaw, May 2016, where we introduced an Oxford Debate session and a new MLT Deal of the Year contest. ECAs have embraced these initiatives enthusiastically, with SACE our first winner while both Sinosure and EDC contributed a lot to the session. Overall, the exchanges at the Warsaw meeting were interesting and informative and the overall impression was that despite difficult market conditions, ECAs will continue to adapt their products and programmes to rise to the occasion. ■

## Investment insurance and other cross border risk insurance

Under INV, Berne Union members report credit insurance for overseas investment against political violence, expropriation, transfer and convertibility risks; non-honoring of sovereign obligations credit insurance products, providing cover against the inability or unwillingness to pay by sovereign and sub sovereign obligors; and all other typical credit insurance protection against political and commercial risks for bonding, untied loans and export credit not insured by official ECAs..

The overall investment insurance portfolio grew by 7% compared to 2014, with the final result of $258 billion. With the minor decrease in the volume of new cover provided (-2%) and still almost $100 billion of new transactions ($98 billion in 2015), it seems the average tenor of recent transactions has not shortened any further. It is worth noting that new cover provided for investment and state obligations grew more than 10% in 2015, and the largest growing portfolio is of the credit insurance of state obligations, growing 35% from $29 billion in 2014 to $39 billion at year-end 2015 and developing further to 43 billion at half-year 2016.

The INV Committee Members accounted a low level of claims payments in 2105 ($151 million), 64% less than in 2014 ($238 million).

In terms of classic investment insurance the largest indemnifications occurred in Libya ($34 million), Turkey ($16 million), Russia ($13 million), Vietnam ($5 million) and Ukraine ($4 million). In 2016 so far, only claims paid on Kenyan investments exceeded $1 million.

Within the insurance against non-honouring of sovereigns the largest claims were paid for transactions in Nigeria ($21 million), Malawi ($8 million) and Vietnam ($5.5 million). In 2016 first half, significant volume of claims were paid for transactions in Tanzania ($4.2 million) and Congo ($1.3 million).

Within the remaining line of investment insurance the largest indemnified claims were related to obligors based in China, Russia and Serbia.

In 2015, the recoveries volume was very low (only 14% of the 2014 amount – $11.7 million) and even though the 2016 first half report shows a higher rate (140% increase), it is still below the performance of the previous years.

## INVESTMENT INSURANCE

*Vinco David, Investment Insurance Committee Chair*
*Christina Westholm-Schröder, Investment Insurance Committee Vice-Chair*


Vinco David


Christina Westholm-Schröder

The Berne Union Investment Insurance Committee, which includes both public and private insurers, currently has 38 members. This mix of membership, with institutions offering not only investment insurance but also credit and other types of cover, provides a diverse and comprehensive understanding of the global risk environment. Also, interestingly, there is an almost perfect correlation between the amount of investments covered and worldwide volumes of foreign direct investment, with about 10% insured by Berne Union members.

Limiting the comments in this article to the core business of investment insurance, the current risk landscape is very much in flux, with two major trends; increased risk in many markets and, at the same time, an increase in capacity among providers. The risk environment is characterized by:

- An overall relative low claims ratio (claims as a percentage of premium income); an average ratio between 10 and 20% over the last few years, but with marked exceptions, both regionally and sector-wise.
- The aftermath of the Arab Spring has caused and is still causing considerable claim payments mainly due to political violence leading to loss of foreign investments. Libya, but also other countries, has been severely affected.
- The conflict in Eastern Ukraine and the current situation in Venezuela are leading to political violence and expropriation claims.
- The drop of commodity prices also impacts investments and likelihood of claims. Although not yet manifested in claims activity among the Committee members, risk in commodity related sectors, such as oil or mining, is rising as governments may be pressured to expropriate or change terms for investments that are not delivering the expected benefits; conversely, investors may interpret low returns as political risks.

Apart from the perception of increased risk, and perhaps counter-intuitively, the private insurance market is currently seeing a substantial increase in insurance capacity caused by new insurers entering the market, putting pressure both on pricing and policy wordings. This increase can be attributed to the challenging investment return environment (and indeed even negative bond yields); with insurers seeking business with better returns, and investment insurance has traditionally offered returns that are both uncorrelated to and offering higher returns than more traditional insurance lines.

**The impact of the downturn can also be seen in what looks like a reverse of a long series of years with very limited and manageable levels of claims. While overall figures are still relatively low compared to exposure levels, 2015 saw a sharp increase in claims, both commercial and political in nature; an increase which we may see prolonged into 2016.**

### Prague Club members

The Prague Club is the home of emerging export credit insurance companies who are often domiciled in frontier markets. Current statistics on the Prague Club members allow us to assess the performance of both ST and MLT insurance activity. Prague Club business remained strong in 2015. The aggregate portfolio saw growth of 1% in overall business volumes with an increase of 54% for premium levels collected. Claims meanwhile increased by 17% and recoveries by 65%. in detail:

Volumes of new ST business for PC members reached $24 billion in 2015. Premiums earned on ST trade receivables where up slightly on 2014 at $78 million, again reflecting continued steady business in this area. Claims payments relating to ST transactions increased by 35% to $40 million.

Following two years of high growth, MLT new business volumes remained flat for 2015, registering a total of $3.8 million. Premiums earned meanwhile almost doubled in 2015 ($258 million), a reflection of the complexity of MLT transactions and the tendency of pricing to follow the risk level of new transactions. Claims figures for MLT business increased to $244 million in 2015 from $214 million in 2014. ■

**Apart from the perception of increased risk, and perhaps counter-intuitively, the private insurance market is currently seeing a substantial increase in insurance capacity caused by new insurers entering the market, putting pressure both on pricing and policy wordings.**

# 3

# Expert analysis

# The OECD Regulatory Framework and the benefits of international cooperation between the ECAs

By Paola Valerio, head of International relations at SACE (Cassa depositi e prestiti Group)

**The OECD Regulatory Framework on Export Credits has ensured fair competition for several decades and it is often quoted as an example of successful international cooperation. The current challenge is the attempt to replicate the model on a much larger and more global scale, as well as the prospect to render it more suitable for an enhanced operational environment.**

## The OECD Consensus: Genesis and major achievements

The OECD arrangement on Officially Supported Export Credits, also known as 'Consensus', has recently celebrated 38 years since its establishment in April 1978. Originally undersigned between twenty participating countries, it now involves the 28 Members of the European Union plus Australia, Canada, Japan, Korea, New Zealand, Norway, Switzerland and the United States. More recently Brazil became a participant to the Aircraft Sector Understanding.

Back in the 1970's, the arrangement was conceived – and subsequently implemented – with the ambitious goal of providing for an overarching framework for officially supported export credits and ensuring a level playing field to exporters. To this aim, the Consensus not only envisages specific terms and conditions by which official support is provided by ECAs, but also encompasses ad hoc consultation and information-sharing mechanisms among its participants. Its overall building process, including ongoing negotiations initiated by members' proposals, is actually based on transparency and peer pressure and its disciplines have since the beginning found recognition under the WTO framework.

Despite its nature as a non-binding agreement or a gentlemen's agreement, the Consensus has been translated into EU Law[1] and has experienced throughout its history a remarkable success in terms of adherence of its participants, as well as a certain adaptability to reflect changes in the financial and industrial markets, the globalisation of international trade and the different challenges set by a fast-changing business environment. Over the years, as the ECA activities gradually shifted towards commercial counterparties besides the traditional sovereign risk insurance, the general arrangement has evolved as to include a common framework for the pricing of private buyer risk based on the obligor's creditworthiness (the Malzkuhn-Drysdale Package) as well as a specific pricing methodology for transactions in high income OECD countries, aimed at avoiding crowding out of the private market. Contextually, in sectors with specific technical and financial characteristics, the applicable disciplines have been set out in separate sections – the so-called sector understandings – which are annexed to the

Paola Valerio

Arrangement and currently apply to ships, nuclear power plants, civil aircraft, renewable energy/climate change mitigation and adaptation/water projects, rail infrastructure and coal-fired electricity generation projects. Such sector understandings reflect the need of certain industries for specific financial disciplines to meet their construction and financing requirements, market and relevant financing practices. Furthermore, as in the case of the sector understanding on renewable energy, climate change mitigation, adaptation and water projects and the most recent sector understanding on coal-fired electricity generation projects[2], the arrangement has also become a policy instrument to reach ambitious and important goals such as the climate change objectives, in line with the unprecedented efforts undertaken by major governments worldwide with respect to environmental issues.

### OECD regulation on policy issues

Besides the terms and conditions set by the Arrangement, defining the most favourable financial package offered by ECAs, the OECD – through the Working Party on Export Credits (ECG) – also provides a forum for discussing and coordinating export credits policies relating to good governance, such as environmental and social due diligence, anti-bribery measures, and sustainable lending.

The potential impact of ECA backed projects on the environment has been on the OECD agenda since 1998, which eventually led to the Council Recommendation on Common Approaches. The recommendation identifies the environmental and social risks that ECAs have to address when underwriting new business, as well as defines sensitive areas where a due diligence has to be carried out even for small-sized transactions – usually outside the scope of the recommendation. The current text (approved in April 2016) encompasses several enhancements, including the screening of any severe project-related human rights impacts and the requirement of complementary standards for social issues (an area where World Bank standards, currently under review, are deemed as insufficient), further to a commitment to report $CO_2$ emissions from all supported projects in the power sector; such improvements are also indicative of the consideration paid by the ECAs and their guardian Authorities to any potential effect triggered by supported projects in the respective country of destination.

Always on the policy end, the keystone to OECD efforts in fighting international bribery is the OECD Anti-Bribery Convention and the Recommendation on Bribery and Officially Supported Export Credits. The recommendation encompasses specific provisions to prevent, detect and investigate bribery of foreign public officials in export credit transactions, including reporting to law enforcement authorities. A peer review process ensures a coordinated approach on the implementation of the recommendations as well as the construction of a body of experience.

**Despite its nature as a non-binding agreement or a gentlemen's agreement, the Consensus has been... a remarkable success in terms of adherence of its participants.**

In addition to the above, the ECG members have also adhered to a set of principles and guidelines to promote sustainable lending practices, aimed at ensuring a consistent approach vis a vis new indebtedness of low income countries.

### The outreach strategy

Following the globalisation of international trade and the increased competition from new players, in recent years the OECD has engaged worldwide with countries that are committed to embracing a more market based economy. The outreach program, addressed to key partners as well as regions of strategic importance (e.g. Latin America), promotes inter alia the participation in joint committees and the adherence to OECD instruments, with a mix of elements determined by mutual interest. In this respect, the success story of Brazil's adhesion to the Aircraft Sector Understanding (ASU) in 2007 was a first precedent: even though not an OECD member and hence not bound to apply the arrangement, Brazil became a participating member to the ASU. This was a crucial milestone in the outreach efforts, particularly as Brazil is one of the main players in the aircraft sector.

Informal talks amongst participants were also launched in order to identify more flexible routes to incentivise non-participants to join the arrangement. Whereas the current procedure foresees that countries primarily need to be OECD members in order to be able to join the consensus, consideration could be given to different approaches that might detach such a prerequisite, to some extent in analogy with the Brazilian case.

Besides the OECD efforts, bilateral outreach talks between United States and China led to the establishment in 2012 of an International Working Group on Export Credits (IWG) outside the OECD context, aimed at negotiating a set of common rules with non-OECD countries – such as China, Brazil, India and Russia. Discussions have focused on specific sectors, while horizontal topics (including interest rates and risk pricing) have been considered only recently. Although the IWG works have not reached the negotiating stage yet, some progress was made in terms of mutual understanding of practices as well as detailed explanation of technical issues. Further and more substantial advancement could possibly be made with the establishment of a Secretary General or any other permanent entity relevant to the IWG that would ensure continuity to the discussion, currently managed with a rotating chair mechanism.

## Enhancing the OECD Framework: Pending issues and challenges ahead

In the most recent years the OECD regulatory framework has appeared less and less able to capture the actual international trade, as non-export related operations conducted by ECAs continue to grow. Products aimed at supporting the internationalisation of national companies, the issuance of surety bonds as well as any form of untied financing not directly linked to national procurement remain outside the scope of the OECD. In order to avoid subsidisation of certain activities, some ECAs apply specific legal frameworks to such programmes (e.g. EU State Aid regulation[3]), however the approach is not consistent amongst different players. Furthermore, even within the current scope of the OECD framework some major pending issues remain due to the existence of significant gaps in the current regulation. The lack of a minimum pricing level in the Ship Sector Understanding, a highly competitive sector, has led to a race to the bottom, which contradicts the actual spirit of the arrangement and the WTO prohibition on subsidies. Similarly, the absence of provisions on a minimum floating rate has determined uneven financial support especially during the financial crisis, triggered by the downgrade of sovereign ratings. Likewise, the lack of a common rating system (with the only exception of the ASU) weakens the pricing provisions, as even within the framework of a common minimum pricing methodology, ECAs may differ on the assignment of risk ratings, driven by their internal risk appetite framework and mandate to support their national exporters.

Also at policy level, the recommendations require a constant monitoring activity as well as periodical updates – as appropriate – in order to address specific needs emerged during the implementation and to enhance and harmonise members' due diligence and KYC practices. The latest update of the Council Recommendation on Common Approaches has just been released, while the review of the recommendation on Bribery is currently ongoing. Potential improvements may feature an extension of the due diligence currently envisaged for exporters/applicants to all relevant counterparties involved in a transaction (i.e. including buyers/borrowers/guarantors) as well as a wider definition of bribery in order to include business-to-business corruption in addition to bribery of foreign public officials.

A robust and consolidated export credit discipline is still important to ensure fair competition among international players. Fundamental changes in the current regulation have become necessary and will need to be carried out in the very near future. Like in the 1970's, international regulators in all countries are now requested of an extraordinary commitment and spirit of compromise to fill in the current regulatory gaps or, alternatively, to re-draft a more ambitious, comprehensive and adequately flexible set of rules suitable to changing market conditions, that may be triggered by competition from powerful emerging economies, growing civil society interests, climate change, globalisation and financial crises. ■

**Notes**

1 EU Council Decision 93/112/EEC applicable to EU Member States.

2 Entering into force in January 2017.

3 Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State Aid in the Form of Guarantees.

# Compliance: A priority for ECAs

**By Lucy Wylde, general counsel and head of compliance at UK Export Finance (UKEF)**

**Compliance risk management should be a priority for any export credit agency. Lucy Wylde outlines how the UK's export credit agency is taking steps to further strengthen the assurance provided around compliance risk.**

For any export credit agency (ECA), following the highest standards of governance, accountability, transparency and risk management should be an imperative. For UKEF, as a UK government department, not only is it a public policy objective to avoid financial loss from transactions tainted by corruption, but to avoid unjustifiable reputational risk through failure to comply with all applicable laws and regulations.

As an ECA and a government department, we have many compliance obligations. These are drawn from a large number of laws, UK government policies, regulations and international agreements. They are as wide-ranging as the Bribery Act 2010; international sanctions legislation; the Equality Act 2010 protecting our employees from discrimination in the workplace; the Equator Principles governing our environmental, social and human rights due diligence; the OECD Arrangement; and, of course, the responsibilities we have as a member of the Berne Union.

## An independent compliance function

UKEF has always had policies and procedures in place to manage risks, but we wish to further strengthen the level of assurance by providing a more holistic oversight of all our compliance processes. To this end UKEF has committed resource to an independent compliance function, which coordinates the oversight of the controls in place to help ensure compliance with the regulatory framework within which UKEF operates.

Lucy Wylde

In line with our holistic approach, we have chosen to adopt a compliance policy with a wide remit that encompasses all our compliance responsibilities whilst at the same time ensuring that we meet our core responsibilities as an ECA and government department. Specifically, our goal is to adopt standards that reflect best practice in the financial services sector.

The compliance function acts as a contact point for other UKEF staff responsible for elements of compliance, and provides guidance and advice to staff across the business to support them in meeting their compliance responsibilities. The objective is to ensure the department is fully engaged and equipped, has the right controls in place,

**For any export credit agency, following the highest standards of governance, accountability, transparency and risk management should be an imperative.**

and thus is an exemplar of best practice in compliance.

The compliance function also works closely with other assurance providers within UKEF. These include UKEF's operational risk function, which oversees the management and mitigation of risks relating to our ability to fulfil our statutory purpose, achieve the financial objectives set by HM Treasury, adhere to international agreements or manage other legal risks. Taken in tandem, compliance and operational risk management provide a second line of defence, with internal audit providing the final link in UKEF's assurance framework as the third line of defence.

Best practice is not static and so we meet with external organisations, seeking input from their compliance functions on control enhancements and exploring how we can adapt and implement these strategies at UKEF. By seeking out improvements made by others we can help ensure that we are at the forefront of industry developments.

## Compliance culture

To be successful, compliance needs to start at the top of any organisation. Overall responsibility for UKEF's compliance therefore sits at the highest levels within the department, including our board and executive committee, which is made up of the most senior staff including the chief executive officer. Our executive committee is charged with demonstrating leadership in compliance through their own individual roles as well as overseeing and assessing the effectiveness of how compliance risk is managed in UKEF. It approves our compliance policy and is responsible for communicating, implementing and ensuring it is followed. In my role as general counsel, I also act as the head of compliance, with responsibility for instilling a compliance culture across the entire department.

While it provides a greater and more robust level of assurance, simply having a compliance function is clearly not enough. The Basel Committee on Banking Supervision has made it clear that compliance can never be the responsibility of a single individual or select group of individuals. Whilst our culture of compliance starts at the top with our board and executive committee, it therefore involves each member of staff playing his or her part in fostering a climate of honesty and integrity and 'doing the right thing'.

**By seeking out improvements made by others we can help ensure that we are at the forefront of industry developments.**

As a result, compliance is one of our five departmental objectives, from which all staff then draw their own individual objectives, sitting alongside other high-level priorities such as performance, efficiency, teamwork and brand. The compliance team is implementing a communication and education plan to help ensure that this is the case and a culture of compliance is embedded across the department.

Robust risk management, rigorous governance and strict adherence to laws and international agreements are an integral part of UKEF's ethos as well as our business activities. As the head of compliance I am confident that our compliance function will play a key part in providing us with assurance that we meet our responsibilities as an ECA and contribute to developing best practice across the ECA field. ■

**Whilst our culture of compliance starts at the top with our board and executive committee, it therefore involves each member of staff playing his or her part in fostering a climate of honesty and integrity and 'doing the right thing'.**

# The cost of emerging from the perfect storm

**By Daniel Schmand, chairman, ICC Banking Commission Advisory Board**

If you were writing a drama about the financial system, then you could not have asked for more material over the past few years. A major and potentially catastrophic financial crisis, the after-shocks of which are still with us, the rise of cyber-crime, geo-politics getting out of control, wave after wave of regulation, and on top of that, the rise of new market challengers in the form of the financial technology sector. It's something of a cliché, but you could not make it up!

Let's be very frank, however. Tighter regulation was long overdue and has largely been a reaction to a collapse in risk management controls and some market ethics. The financial crisis revealed some huge problems and behaviours that just could not be tolerated any longer. Since 2008, regulators have had to ensure there is no systemic risk in the market, that banks are stable and robust to withstand shocks and that investors and savers have an appropriate level of protection.

The crisis, and its fall-out, have placed compliance very much in the front-line as banks and other financial institutions deal with the new, developing business paradigm. While the compliance officers and their teams represent the public face of the commitment to regulatory best practice, there is a growing feeling that compliance is the responsibility of everyone.

Daniel Schmand

The regulators set the rules, but it is the job of the practitioners to ensure that individual organizations implement and monitor the business and ensure they are complying with laws, regulations, standards, codes of conduct and accepted market behaviour.

The result of this is that banks are spending increasing amounts of money on ensuring their compliance regimes are robust, appropriately skilled and right-sized. Consequently, the cost of compliance is rising at a time when the financial burden of pursuing traditional business models, such as correspondent banking, are also climbing substantially, to such an extent that banks are scaling-back correspondent banking networks. The implications of this growing trend are significant – some banks will find it impossible to maintain US dollar and euro clearing accounts or confirm letters of credit. This not only impacts the banks themselves but also the economies of the countries in

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which they are located. The old correspondent banking model, so long part of the lifeblood of banks, is also under threat from new ideas and new competitors from outside of the industry.

It's not just compliance that is seeing a rise in costs and headcount. Supporting functions, such as business control offices, audit and risk, are also in the ascendancy. Statistics from the European Central Bank (ECB) provide evidence of the shift in expenditure to ensure bank infrastructure is safe and sound – in 2015, the ECB said that the appropriate size of an audit department, for example, was approximately 0.9% of the total global workforce. Indeed, from a business perspective there is no longer a single compliance officer, but specialists in anti-bribery and corruption, anti-financial crime, sanctions and embargoes and anti-money laundering.

The involvement of an ever-increasing number of compliance gatekeepers, while a necessity, can add weeks to the lifecycle of a deal. Furthermore, the prolonged process around client onboarding is costing time and resources. The industry is currently working on utility type systems that can introduce standardization, notably through instruments like legal entity identifiers, and consistency to the act of client adoption, but these are still in their nascent stages. The effect of delayed indicative offers and credit approval, for example, can be frustrating for clients. As we move out of a huge transitionary phase, the industry has to balance the need for a more responsible regulatory environment with commercial requirements.

A lot of banks and financial institutions have become more selective in the deals, clients and counterparties they engage with, often deterred by the regulatory ask or the practical hurdles in meeting all requirements. The huge growth in control functions across the industry has simply made it that much harder to do business. Some banks have trimmed back their client lists or retracted in certain areas because of a reduced risk appetite or simply through cost restrictions.

There are broader considerations other than those affecting banks, however. While banks' reluctance to get involved in certain deals, for a variety of reasons, undoubtedly impacts the clients, alternative investors have started to fill the void left by the banks. Financial technology companies are providing payment services or FX services by matching buyers and sellers online without the need for extensive KYC procedures. This brings a new dimension to a system that has been in place for decades.

**It's not just compliance that is seeing a rise in costs and headcount. Supporting functions, such as business control offices, audit and risk, are also in the ascendancy.**

Where does this leave us as we look back eight years since the onset of the financial crisis? Cost is not just measured in money, but also in terms of time and opportunity. Much of banks' capacity is now being absorbed in developing more stringent anti-money laundering and anti-financial crime techniques and processes. We all agree that there are legitimate reasons for a more rigorous approach, but there is also a need to ensure that these additional layers of scrutiny are correctly calibrated to do their job: ensure the safety and stability of the financial system. In the coming years, I believe it is the shared responsibility of industry leaders and global regulators to work together to create a more safe and sound financial system. But this resiliency and this trust will have to be rebuilt over time, and can only come from dialogue which is candid and open. And I invite each of you to join us as we begin this journey towards greater resiliency and openness. ■

**Tighter regulation was long overdue and has largely been a reaction to a collapse in risk management controls and some market ethics. The financial crisis revealed some huge problems and behaviours that just could not be tolerated any longer.**

# Reinsurance: An ECA point of view

**By Adi Gross, chief underwriting officer, ASHRA**

For many years the linkage between export credit agencies (ECAs) to the reinsurance market was related only to their reinsurance treaties or special arrangements under their short-term credit insurance business (STC).

ECAs in general have continued to manage their Medium and Long Term Credit Insurance lines (MLTC) within the framework of their own governments. Not only was that the decision for supporting a MLTC project was made by the government or by its ECA, but taking the risk itself as well was fully governed by the ECA's government, taking the obvious advantage of its "deep pocket". In the traditional world where the majority of credit insurance lines were provided to STC, MLTC was rarely used or mostly used for special projects that were linked easily to government support.

## ECA to ECA

The first change was less connected to risk management, as you may have guessed, and more related to national content issues and to the increase in volumes and the complexity of projects. It is quite easy to understand why a government should not have to cover their counterpart country's portion especially if the case does not fit

Adi Gross

exactly to their national content regime. The obvious first alternative was to split a specific project into portions; however, it may negatively affect the financial structure and costs. The second alternative is to cooperate and nowadays every ECA knows that whenever a major portion of their project is related to another specific country, they are welcome to approach their counterpart ECA for risk sharing by way of reinsurance agreement with classic follow the fortune approach.

## ECA to private

The second change was the relatively new activity of the private credit insurance companies in the medium and long-term credit and political risks insurance areas. And especially, their active entrance to the Berne Union as members in the 1990s. Such credit insurers have acted as a bridge between ECAs' hesitation to use the market's service, and the new needs. When a project has

**The advantage of private market insurers was always about their availability, speed and flexibility. Among their biggest advantages over ECAs are their ability to cover risks of export finance and trade finance, without any linkage to national content and without any obligatory requirement for down payment.**

required, for instance, a downpayment loan (15%) in parallel to the ECA Loan (85%), the private members were there to provide coverage. No doubts then that after a while some ECAs have started to cooperate closely with private members, in their own portfolios.

**ASHRA is considered to be a small-medium ECA. Using private market capabilities, it leverages its ability to service Israeli exporters and is at the forefront in major projects.**

The advantage of private market insurers was always about their availability, speed and flexibility. Among their biggest advantages over ECAs are their ability to cover risks of export finance and trade finance, without any linkage to national content and without any obligatory requirement for downpayment.

However, cooperation through ECA to private reinsurers is still limited. In my opinion it is mainly due to the gap between the cultures. Is the private market reinsurance policy clean enough for ECAs to rely on? Or, what are the exclusions of the private insurer reinsurance? What are the approaches of the private insurer and the ECA with respect to claims process and especially to the Paris Club? Can private reinsurer meet the OECD's premium rates? Furthermore, difficult dilemmas with different answers, those who were able to be flexible, are rewarded with excellent partnerships on both sides.

### Types of reinsurance

Structuring reinsurance can be approached in different ways, which should be chosen according to the insurer's needs.

Unlike short-term credit reinsurance, the almost automatic structure for MLTC is to have a quota-share facultative reinsurance agreement toward each insured project, or for several. In such cases the reinsurer follows the insurer's policy, and in case of a claim pays its quota share.

Excess of Loss (EOL) is another good option to use the service of the private market. This is where certain risks are divided into layers. For instance: the first layer of risk is covered by the ECA, the second layer by the reinsurer, and third by the ECA again. In such cases the reinsurer will only be obliged to pay a claim after the entire first loss is paid by the ECA. Taking a decent portion of the first risk by the ECA can be helpful for pricing matters, for handling the policy and the claim process as well. The main advantage for this option is mainly for portfolio risks, or country exposure risk, and less for single risk.

An increasingly popular option is using a treaty for MLT. It may be more useful for relatively large ECAs with a decent amount of MLT projects on a yearly basis. On one hand, the advantage is that the reinsurance process for each insured project is faster as the documentation is finalised in advance and underwriting is done by the ECA solely. On the other hand, a treaty renewal is required on a yearly basis and ECAs are requested to cover whole turnover or a large portion of their portfolio.

### ASHRA's experience with MLT reinsurance

ASHRA is considered to be a small-medium ECA. Using private market capabilities, it leverages its ability to service Israeli exporters and is at the forefront in major projects.

The first time ever that ASHRA reinsured a project with private market involvement was in the early 2000s. At that time ASHRA's (formerly IFTRIC) exposure to Romania and Venezuela was quite high and the political risks of both countries had increased dramatically at the same time. ASHRA and its guardian authority have decided to look for ways to reduce exposure and using a private market player wasn't an obvious choice, at that time.

Since then ASHRA has had some major achievements in the reinsurance field:

1. More than 100 projects were reinsured
2. More than 30% of the current exposure is reinsured
3. Reinsured and insured major ECAs
4. Multi-reinsurers' projects
5. Excess of Loss reinsurance solution
6. Direct reinsurance or through brokers

**Bottom line**: As the requirements for ECAs' risk management are always growing, using private market solutions to reduce or share risks is not a secret anymore. ECAs are still the best partners for banks in their own territory. However, differences in risk appetite and credit tenors are not seen as often, and private market players are highly motivated to cooperate with ECAs and not to replace them. ■

# Competition, the ECAs and the private market

By Charles Berry, Chairman, BPL Global

**Most ECAs in the developed world do not compete with the private sector for 'marketable' risks; but when it comes to 'non-marketable' risks, life is a lot more complicated.**

A degree of competition between ECAs and the specialist credit and political risk insurance (CPRI) market has become inevitable and appropriate because, of necessity, both now often cover the same type of risk. We welcome this choice for clients (whether exporters or financiers) but issues remain:

- First, many in our industry continue to deny the existence of this competition. This denial threatens the proper development of our market.
- Second, for the competition between ECAs and the CPRI market to be fair, ECAs need to comply with the OECD Arrangement with its minimum premium rates, and there needs to be a level playing field on premium taxes.
- Third, some ECAs have begun to compete with their clients. When an ECA approaches the CPRI market for facultative reinsurance, simultaneously as its client approaches the same insurers for cover on the same transaction, ECA and client find themselves in competition for the same private market capacity. We need safeguards to ensure that when pursuing reinsurance, ECAs do not restrict client choice.

## Capacity constrained marketable risks

Our views challenge the traditional narrative, enshrined by the European Commission, that private insurers and ECAs operate in different risk categories, with private insurers covering 'marketable' risks and ECAs covering 'non-marketable' risks.

The EU's definition of 'marketable' risk, though narrow, is reasonable: short term business in the EU and a handful of developed countries is indeed the only area of the business "where there is sufficient private capacity to cover all economically justifiable risks". Therefore the EU ECAs do not normally cover 'marketable' risks so defined.

Charles Berry

The problem is that everything else is considered 'non-marketable', a view that is confounded by the activities of the CPRI market. BPL Global's portfolio of close to $40 billion of live policies represents about 15% of the CPRI market and is typical of the market as a whole. Less than 5% of our portfolio is 'marketable' under the EU classification, and this shows that there is a market for most so-called 'non-marketable' risks. Traditional thinking is further confounded by our portfolio being predominantly medium and long term (MLT) risk, and by it revealing that CPRI market insurers have proportionally more exposure in high risk emerging markets than the ECAs do.

Of course some risks remain truly non-marketable, either because of size or tenor, particularly for private sector obligors. However, the clear majority of risks deemed 'non-marketable' are individually within the risk appetite of the CPRI market. But collectively they are not fully 'marketable' in the EU sense, because there is not sufficient private capacity to cover all such risks. There is therefore a third category of risk, "capacity constrained marketable risk", where the CPRI market is very active, but ECA participation is still essential.

The CPRI market's capacity constraints arise from the concentrations by obligor and by country that inevitably arise in export credit insurance, particularly in emerging markets. CPRI market capacity is a scarce resource, and its providers underwrite selectively because they need balanced risk portfolios. So a risk may be overpriced or even unacceptable this week, simply because the market wrote a large identical risk last week. Country aggregate is a particular concern. From Berne Union figures we estimate that total global demand for MLT cover in high exposure countries like Brazil, China, Russia and Turkey may approach $50 billion. The CPRI market can meet at best perhaps 25% of that total demand. These very real capacity constraints are not going to change soon.

The need for government support to address aggregate exposure and risk concentrations is well known in other classes of insurance, such as terrorism and flood risk. The export credit insurance market is unusual because, for historical and structural reasons, government support comes as direct insurance, rather than as reinsurance sitting behind the private sector. It is this necessary presence of ECAs in the direct market which makes our class of insurance complicated. Given the rise of the CPRI market, we need to face up to the inevitable competition that has arisen.

## Competition is now inevitable

Competition is indeed inevitable for capacity constrained marketable risks. Consider 50 clients who each require MLT policies on the same obligor in a medium to high risk country, whose risk is well within the appetite of the CPRI market, but where the market has enough aggregate capacity to write only 10 to 15 of these policies. How should these essentially identical risks be allocated between the ECAs and the private insurers?

If ECAs were serious about not competing with the private market, they would have to withdraw their support until the private market capacity was exhausted, holding back even when the price of the private insurance rose well above the OECD minimum premium rates as it became more scarce. This would be a disaster for clients. If ECAs only offered cover on an obligor when the CPRI market had run out of capacity, they would simply exacerbate the imbalance between demand and private market supply, with the obvious consequences.

So while some ECAs maintain that they do not compete with the private insurers, in practice they issue cover where private market cover would be available, albeit on less favourable terms. The ECAs cannot fulfil their role without competing with the private market. If a European exporter with a CPRI market quote at 125% of the OECD minimum price, finds itself in competition with an Asian exporter with ECA support at the minimum price, the European ECA has little alternative but to put its client first, and undercut the private insurance market.

## Competition is appropriate

However, the policy of not competing with the private market is not only impractical, it is misguided. Consider the effect of the policy on the clients' behaviour. The clients naturally prefer the established ECAs, to the less well established private insurers. So the ECA policy of not competing with the private market becomes in effect a threat to withdraw ECA support if the client obtains terms from the CPRI market. We cannot think of a better way of discouraging clients from approaching the CPRI market, or of perpetuating the ECAs' de facto monopoly. In any other context, the ECAs would be accused of anti-competitive behaviour and abuse of their dominant market position. The CPRI market accepts that it is the new entrant and has to prove its worth. But ECAs should encourage clients to explore the

**If ECAs were serious about not competing with the private market, they would have to withdraw their support until the private market capacity was exhausted, holding back even when the price of the private insurance rose well above the OECD minimum premium rates as it became more scarce. This would be a disaster for clients.**

private market, not position the private market as a threat to the still necessary ECA supply. Is it surprising that many clients treat the CPRI market as a market of last resort, only to be approached when ECA cover is not available?

The policy should be reversed. All ECAs need to make it clear that regardless of any terms obtained from the CPRI market, ECA support will still be available subject to normal eligibility and underwriting criteria, and subject to the OECD Arrangement. ECAs need to encourage choice. This choice will benefit clients, and provide a more transparent and efficient allocation of risks between public and private sector insurers.

In accepting the existence of competition our industry should take comfort that competition between an ECA and the CPRI market is very different to the head-to-head, destructive competition that occurred amongst ECAs before the OECD Arrangement. If an ECA loses out to the CPRI market, its client has not lost to a foreign competitor but simply found a better insurance alternative. Furthermore, when the CPRI market loses a transaction to an ECA, its scarce capacity remains available for what may well be a better opportunity down the road. Like many participants in complex industrial markets, the private insurers will play to their competitive advantages of flexibility, speed of response and freedom from the constraints of eligibility criteria and the OECD Arrangement. This is why clients see the ECAs and the CPRI market as complementary. But this coexistence is the result of competitive strategy, and the two remain competitors whenever clients can choose between them for all or part of a risk.

### Competition needs to be fair

The real question facing our industry is not whether competition between the ECAs and the CPRI market does or should exist, but whether it is fair. Here the OECD Arrangement takes on a new importance. As well as its original purpose of limiting government subsidy for export credits, so preventing the market distortions that subsidy can create, the arrangement, with its minimum premium rates, now serves a second purpose of ensuring that the ECAs compete fairly with private insurers. Private insurers have an interest in ECAs abiding by the arrangement and in the Arrangement's minimum premium rates fully reflecting both risk and the cost of capital.

The CPRI market also needs a level playing field on premium tax. We are not aware of any EU ECA that is subject to premium tax. It follows that no private insurer operating at

## Is it surprising that many clients treat the CPRI market as a market of last resort, only to be approached when ECA cover is not available?

the same level of the market as these ECAs, should be subject to premium tax when covering 'non-marketable' risks. The Berne Union should take up the cause.

### 'Horizontal' risk sharing

With both ECAs and the CPRI market competing for capacity constrained marketable risks, new opportunities have emerged for risk sharing between the two. This risk sharing is 'horizontal' when it takes place across the market, between insurers operating at the same level of the market who can quote against each other for all or part of a risk. With our base in the London subscription market, we of course welcome such risk sharing when it serves the client's best interest.

In particular we agree that clients can benefit on certain transactions by the CPRI market reinsuring an ECA. However, where this risk sharing remains 'horizontal', an ECA pursuing such reinsurance may find itself competing with its client for the CPRI market's capacity.

Therefore, where the client might itself be in negotiation with the CPRI market, the ECA should first obtain the client's permission before approaching private insurers for reinsurance. If an ECA fails to do this, its intervention in the market may limit the client's choice and thereby affect the price the client can obtain. Simple examples illustrate the point:

- Even when a client knows that Insurer A, B and C would all be acceptable to an ECA needing reinsurance on a transaction, the client should be able to restrict the ECA to approaching only Insurer C, where, for example, it needs Insurer A's capacity to support a financed down payment, and

Insurer B's capacity to cover an onshore portion of the project.

- In a situation where Insurer A has offered terms that undercut the ECA's price, but where the client needs Insurer B's support to complete the private market placement, the client should be able to prevent its ECA approaching Insurer B with an offer of reinsurance at the higher ECA price. By unilaterally entering the market and securing Insurer B's capacity for itself, the ECA, maybe unwittingly, would scupper the CPRI market better offer.

The above rule – that an ECA needs its client's permission – will provide the client with the oversight and control it needs to ensure that risk sharing, whether by co-insurance or reinsurance, between public and private insurers operating at the same level of the market, leads to the best result for the client.

If ECAs do not immediately see the need for this rule, it indicates that there is an opportunity for the Berne Union to perform a valuable service for its ECA members by reminding them that they are undertakings subject to competition law; by helping them to identify when they are operating at the same level of the market as the CPRI market insurers, and when therefore risk sharing would be horizontal (as not all reinsurance of ECAs by private insurers is horizontal); by reminding them why competition authorities remain deeply suspicious of all risk sharing and 'co-operation' between insurers operating at the same level of the market, particularly when they involve insurers with a dominant market share; by understanding how following the best principles of the subscription market can keep the competition authorities happy; and by understanding why the process of horizontal risk sharing should be controlled by the client, not by the insurers or any one of them.

ECAs have entered unfamiliar territory. Used to the OECD Arrangement and its laudable aim of limiting state subsidy, ECAs now find themselves in an environment where a similar arrangement or understanding between an ECA and a private insurer would breach competition law. No private insurer is bound or could be bound by the Arrangement. Indeed, freedom from the OECD Arrangement's constraints is a souce of competitive advantage to the CPRI market.

## Conclusion

Competition between ECAs and the CPRI market is inevitable and appropriate given the fact that most risks once deemed 'non-marketable', are today in this new category of 'capacity constrained marketable' risks. In conclusion, though, there are some real benefits that flow to ECAs from recognising this new category of risk.

For despite the fact that the ECAs collectively remain a vital part of the world's commercial infrastructure, supporting trade and development globally, many individually still struggle to make their case to their government owners. The reason is that the narrative of ECAs only covering 'non-marketable' risk must be inherently unattractive: it inevitably paints a picture of the ECAs as a dumping ground for sub-standard risks rejected by commercial insurers. This conjures up images of tax payer subsidy and corporate welfare, images that persist, despite the Berne Union ECAs' very healthy financial performance over the last 20 or so years.

The narrative around capacity constrained marketable risks presents a more complex, but more accurate and pleasing picture of the ECAs' role. The market gap is different but clear: not a lack of risk appetite at the transaction level, but a problem of capacity aggregation at the portfolio level. This narrative still sees the ECAs fulfilling a vital role: this they can do on commercial terms, without providing a subsidy, and earning a return for their government backers. Abiding by the OECD Arrangement and following sensible policies, the ECAs can provide a haven of consistency, stability and capacity around which the CPRI market can ebb and flow, guided by a normal market process of client choice. ■

**For despite the fact that the ECAs collectively remain a vital part of the world's commercial infrastructure, supporting trade and development globally, many individually still struggle to make their case to their government owners.**

# CIRR: Analysing its contemporary importance

**By Henri d'Ambrières, HDA Conseil**

Minimum fixed interest rates are as old as the OECD Arrangement on officially supported export credits. Then the system was fine-tuned in 1983 and these fixed rates were called CIRR (commercial interest rate of reference). Some ECAs offer these kind of fixed rates, directly or through other public agencies, while other ECAs do not offer these rates to their exporters. A few ECAs that offered it 10 or 20 years ago stopped, generally for budgetary reasons. Interestingly, the British scheme which was scaled-down in 2005 and closed in 2011 for budgetary reasons, was relaunched in 2014 by UKEF in order to better support exporters. As current fixed rates are very low and most experts expect, and sometimes also hope, for an increase, guardian authorities of the ECAs face an interesting challenge: does the support to exporters justify a scheme which might be costly for the taxpayer?

## 1. Brief description

CIRR are fixed rates used for export credits and supported by public authorities. The OECD Arrangement defines some rules regarding CIRR. It is now constructed as the sum of Treasury Bonds (with a duration close to the average repayment period of the export credit) plus a margin of 100bp, and if the export credit benefits from an official funding with a fixed rate, the CIRR is the minimum applicable fixed rate.

While commercial loans with fixed rates made available to corporates are usually used with a unique drawing and a rate determined on the date of the drawing, CIRRs are fixed rates which are not offered by the market as they include three options:

Henri d'Ambrières

- The first option is that the interest rate is determined before the signing of the export credit; it can be fixed on the date of signing of the commercial contract (so the parties are granted a delay of a few months to sign an export credit, without being subject to variations of fixed rates over this period). This option is free.
- The second option is that the rate can be fixed on the date of the commercial offer of the exporter (so a few months ahead of the signing of a possible contract). The price of this option is a surcharge of 20bp on the interest rate if the credit is signed. There is no fee charged if the commercial offer fails or if the export credit is not signed.
- The third option is that the loan is not used at once on the day upon which the rate is determined; it can be used through one or multiple drawings for years after the signing of the export credit, without any previous commitments on the dates of drawings which are only made according to the execution of the underlying commercial contract (and not predefined). This option is free.

Some rules regarding the delays of validity of these options (and renewals) are mentioned in the Arrangement but interpretations differ from one country to the other.

CIRR can be extended through three different channels :

- Some ECAS can act as direct lenders and offer CIRR, using funds usually brought by their Treasury with fixed rates.

- For loans granted under a pure cover scheme, commercial banks can, according to the ECA,
  - Ask for an ad-hoc refinancing to public institutions (such as KfW Ipex in Germany or ExportKreditt in Norway)
  - Use their own funding and enter in an Interest Make-Up (IMU) agreement with a public institution (which will exchange interests calculated with the CIRR against interests calculated on a floating basis). This exists in Belgium, France, Italy, and Spain, for example.

## 2. Why does it make sense to use CIRR?

There are several reasons why CIRR are used in export finance:

- The need for a fixed rate, linked to:
  - A request of the borrower, especially if it is a Sovereign entity used to borrow only with fixed interest rates
  - A corporate borrower which prefers fixed rates for its business plans and/or does not have the capacity to manage floating rates over a long period
  - The need for a fixed rate to discount a supplier's credit
- The flexibility of CIRR vs traditional fixed rates during the drawing period, as drawings are only made according the execution of the commercial contract with no financial constraints linked to a financial timetable. The borrower is not exposed to replacements costs which would appear with a loan fully drawn at the beginning, or it does not take the risk of future fixed rates (at the end of the construction period).

In addition, it is often the only way to get an export credit with a fixed rate. Most banks do not offer loans with fixed rates and do not propose either Interest Rate Swaps (IRS) attached to an export credit signed with a floating rate as breakage costs are often not covered by ECAs. In addition, regulatory costs are expensive if the borrower is poorly rated and the IRS has a large duration.

Some borrowers have also realised its financial advantages :

- Two options (delay for the signing of the export credit and drawings during the construction period) are free options and in some cases the choice between the floating rate and the fixed rate has only to be made upon the date of the first drawing. With a unique drawing, the choice might then be delayed for years. If rates are declining, the borrower can renounce to the option at no cost without infringing the Arrangement.
- As CIRR are constructed according to the duration of the repayment period, for loans with very long construction periods, some borrowers are asking for very short repayment periods and able to get cheap rates, based on two-year T bonds, for six-year credits.

Finally, for some ECAs, the recourse to CIRR, with prevailing rates, might also be a way to limit credit risks, if floating rates (and then interests calculated on these basis) were to increase substantially in the next five to ten years.

## 3. Are there other ways to get fixed rates?

The rules prevailing on capital markets (with bond issuances) also prevent the recourse to flexible solutions, included in the CIRR, unless there is one unique drawing.

Long-term fund providers such as pension funds are looking for long-term investments with fixed rates but today their capacities to manage export credit policies and a calendar with uncertain dates of drawings are limited.

## 4. Can ECAs afford CIRR ?

Some borrowers are reluctant to use fixed rates as they might be lower a few years later. This was probably more accurate in 1995 when US dollar CIRR rates at 8.5 years were at 8.8% but with prevailing rates (2.33% on 1-9-2016) this risk is probably remote.

More importantly, the CIRR exposes guardian authorities to financial risks and attached costs.

The first risk is linked to the funding of the loan.

a) if the CIRR loan is funded by the ECA or a public authority through a refinancing, this entity will have to use its financial resources at fixed rates, taking a risk of replacement or a risk of a future increase in fixed rates.

b) if the CIRR loan is funded by a banks using an IMU, the public entity is taking the risks of increased floating rates in the future.

In both cases, these risks could be covered by appropriate financial instruments which can be paid using the 100bp margin added to T-bonds. This would probably be better done if the durations used as reference for the CIRR rates were aligned on the average durations of the export credits including their drawing period. In addition, CIRR would increase with the inclusion of the drawing period in the average duration.

With an IMU, the public entity is also taking the risk of a widening gap between the CIRR (based on T Bonds) and the index used for floating rates (based on interbanks' lending). This difference measured by mid-swap rates measures somehow the differences between the creditworthiness of Sovereign entities and banks. We are now coming again to the situation which prevailed 10 years ago and the high spreads registered in 2011 were for the benefit of the CIRR managers.

**The possibility of offering export credits with CIRR rates is a good tool to support exportation contracts as it allows to combine the need for fixed rates and the need for some flexibility which does not exist on financial markets.**

A second risk is linked to an early repayment of the loan. If it is a voluntary prepayment, the Arrangement mentions the need to ask for breakage costs so the financial risk for the public entity is a remote one. If the early repayment of the loan originates in an event of default, the financial risk created by the CIRR will only appear if the ECA decides to indemnify the bank at once and not according to the original repayment-schedule. In the second case, the risk remains the original credit risk accepted at the inception of the operation, as it would have appeared with a loan with a floating rate. And the choice of an early indemnification remains the choice of the ECA, except if there is a repossession of the financed asset (which might only happen for aircraft and ships). The rules applying to aircraft limits the usage of CIRR. Hence the major risks from a CIRR angle might appear in shipping and do not really exist for other goods. If market solutions are considered, the need for a cover of breakage costs also exits.

A third risk is linked to the options embedded in the CIRR. These options might be very costly and are often offered at no cost.

Some countries do not use all the flexibilities provided by the Arrangement while others do. And some delays, especially in the case of renewals, are not clearly defined, if they are.

Some delays (expressed in months) are often required for the formalisation of export credits and the risk of delays in the drawings will always remain. They can be probably covered by the 100bp margin embedded in the CIRR.

While it is probably difficult to ask an exporter or a bank involved in a bidding process to pay for offering a CIRR, it should be possible to ask borrowers to pay for some options, once a project is awarded, or to commit upon the signing of the export credit on the recourse to the CIRR without waiting for the end of the drawing period.

This might create a need for some clarifications in the Arrangement to prevent competitions among ECAs (or providers) on the extension of the CIRR.

While some countries stopped to offer CIRR for losses incurred through this system, other countries claim for positive results thanks to appropriate financial covers.

## Conclusion

The possibility of offering export credits with CIRR rates is a good tool to support exportation contracts as it allows to combine the need for fixed rates and the need for some flexibility which does not exist on financial markets. Alternatives through markets do not really exist for the time being.

The financial costs linked to their management can be probably covered in most cases when loans are drawn; they require adapted cover policies of interest rates.

The recourse to the appropriate durations (including drawing periods) used as references for the establishment of CIRR rates and the billing of some options (such as the possibility to wait for the end of the drawing period to make a decision on the recourse to the CIRR) used by clever borrowers are tools which might limit some financial risks assumed by public entities. And some clarifications in the OECD Arrangement might be required to prevent unnecessary competition. ■

# The era of regulation – part two

**By Ralph Lerch, chairman of the Export Credit Working Group at The European Banking Federation**



### Why do concerns on the future of export finance become apparent in the leverage ratio (LR)?

There is little doubt about the stabilising function of Export Credit Agency-backed export finance for exports during crisis times as the post-2008 renaissance illustrates. Since then we have been living in uncertain times with political instability and volatility in currency exchange rates, interest rates and raw material prices. Good reasons for an ongoing momentum and a bright future for ECA-backed financing. In addition, European industries are facing huge competition worldwide with Asian economies and emerging markets also seeking to participate in global markets. Consequently, trade and exports should be promoted further.

But why then do we observe a decline in ECA volumes under the OECD arrangement when Asian ECAs are still on the rise? In 2015 it was estimated that more than 50% of worldwide ECA business was covered by Asian ECAs. In parallel, the ECA deals reported to tagmydeals declined in 2016 by almost 50% in comparison to 2014.

### ECA growth is mainly in countries with less regulation

What are the potential reasons for this change? It would be too simple to refer to regulation only. In some economies and industrial sectors, the investment climate is so depressed that even ECA support is ineffective in convincing investors to go for capital expenditure (CapEx). There are also strong indicators that the adoption of Basel III regulation within banks can be seen as a negative catalyst especially for ECA backed-export credits. The ECA business in Asia is dominated by public banks and not bound to regulation. Other major growing ECAs located in non-OECD countries, e.g. India,

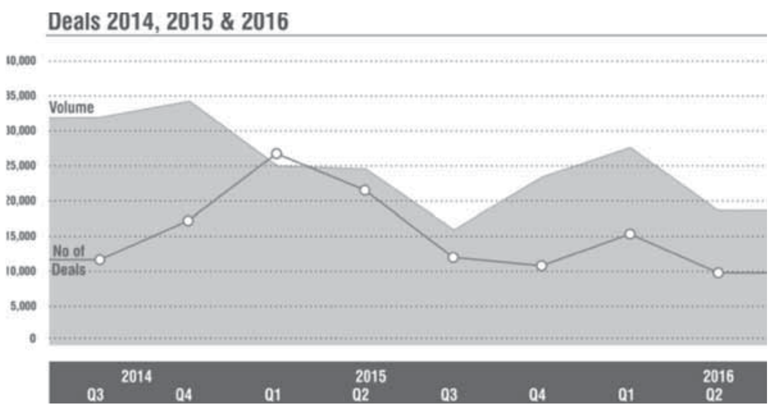
Ralph Lerch

Brazil, Russia with supporting public banks, are also exempt from harsh banking regulations.

Commercial banks, subject to the Basel rules on the other hand, have to team up more often to source bigger deals and seek off-balance sheet solutions to pass equity tests for stressed scenarios. A number of banks have already reduced their export finance capacity or have shut down this section completely.

Whilst the greater reluctance for SME transactions today is mainly based on the results of much stricter governance (risk analysis + know your customer, anti-money laundering etc.), and the need to reduce costs allocated to the management of smaller operations, the drop in capacity for bigger deals is further due to the most critical element in regulation for export finance:

**Graph 1: Evolution of ECA volumes 2014-2016 (TXF data based on tagmydeals)**



the leverage ratio. Consequently, banks are in the midst of a transitional process from a book-and-hold approach to the originate-to-distribute model and ECAs start (or continue) to focus on direct lending options.

Why is the leverage ratio so fundamental to the future of long-term export finance solutions for the industry?

## Leverage ratio, a valid approach to regulate banks?

After a period of ultra-liberal banking supervision and regulation during the 1980s and 1990s, the financial crisis of 2008 has shown the disadvantages of excessive leverage in the banking system. Basel I categorised five buckets of bank assets with different capital requirements. From this period of time 8% is still known as some sort of general equity, underlying and 0% government risk, as well as for ECAs.

Basel II was an attempt to limit economic leverage and required advanced banks to estimate the risk of their positions and allocate capital respectively. Nonetheless, the results as evidenced by the financial crisis were a disaster for the reputation of banks' ability to calibrate their own risk models in order to avoid major losses.

As a result, the Basel committee for banking supervision (BCBS) proposed the implementation of a leverage ratio as a simple, transparent, non-risk sensitive measure and backstop to the risk-based methods/requirements (BIS: Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010). In 2013, the European Union transferred the project of the leverage ratio into European law, i.e. CRR/CRD IV.

The leverage ratio is defined as the ratio of Tier 1 capital (numerator) and an exposure measure (denominator):

$$\text{Leverage ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}}$$

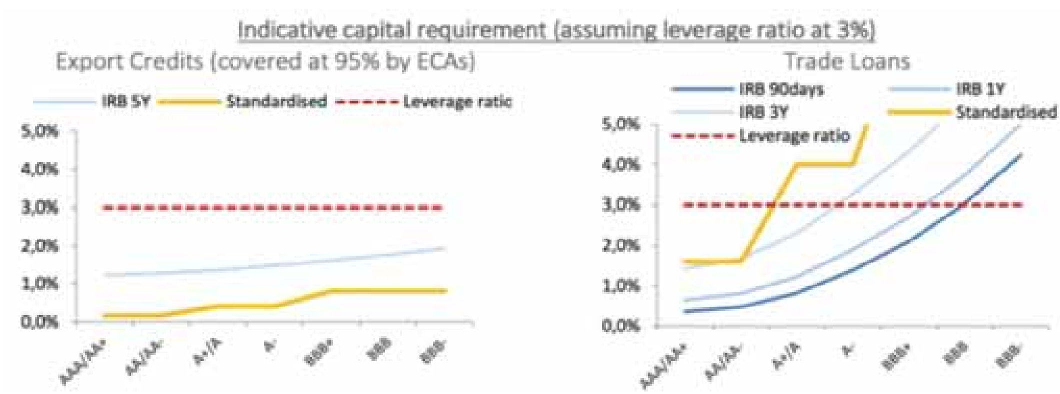
After a period of observation and testing, the leverage ratio is expected to come into force on 1 January 2018. In January 2016 the oversight body of the BCBS announced an in-principle agreement to apply for a minimum level of 3% based on Tier 1 capital.

Fundamental to assessing the impact of such a leverage ratio on ECA-backed export finance, is understanding the changes in relation to what was practised previously. In contrast to short-term trade, the gap between the current approach in export finance indicates a substantial increase in underlying capital, especially for ECAs, backed by favourable sovereign ratings, independently of whether banks use the standard approach (KSA) or the internal rating-based approach (IRBA), see Graph 2.

The European Banking Authority (EBA) admitted that: "by design, the non-risk-based leverage ratio may incentivise financial institutions with low-risk business to diversify asset portfolios into high-risk business, in particular when applied on a stand-alone basis". This is true, especially if the management of a bank has to decide between a 15-year transaction (ECA) and (riskier) business with much shorter time periods. In times when predictability of sufficient underlying capital is jeopardised by steady stress tests, it is unlikely that a 15-year ECA-backed transaction will prevail in comparison to a much riskier transaction with a three-year tenor.

It is also wishful thinking to expect margins

**Graph 2: Comparison of Basel II and Basel III impact on ECA-backed business (ICC)**



**After a period of observation and testing, the leverage ratio is expected to come into force on 1 January 2018. In January 2016 the oversight body of the BCBS announced an in-principle agreement to apply for a minimum level of 3% based on Tier 1 capital.**

for ECA-backed business to be easily raised in order to convince the bank's management of higher profitability. ECA business is already profitable due to a low-risk profile (as confirmed by the International Chamber of Commerce (ICC) Medium-to Long-term trade (MLT) register report). Pricing for ECA-backed export credits is mainly based on costs of funds, costs of capital, overhead costs and risk-related costs derived from PDs of the borrower and the risk mitigant (sovereign backing the respective ECA). And it has still to be attractive enough to support exporters in global competition. Taking into consideration that export finance business worldwide is mainly executed by Global Systemically Important Institutions (GSIIs) the leverage ratio might be even higher than 3% in the future.

One of the major suspicions of the EBA during the discussions and hearings was a potential excessive growth in business which would be exempted from the leverage ratio or otherwise preferably treated. We argued the ECA-backed export finance is limited by nature as a counter-cyclical instrument to overcome market gaps in crisis times, so growth is restricted. In addition, the OECD arrangement prevents ECAs and banks from too aggressive an offering.

What is more, based on a closer look at the various stages of a specific ECA transaction, the challenges of a simple leverage ratio are evident (see Graph 3).

***Phase 1: commitment to final ECA approval***
Depending on the procedure of the respective ECAs there is sometimes a period of several weeks/months from an initial commitment to a final ECA approval. During this period the bank's commitment is always subject to final ECA cover, i.e. conditional. For such a period a lower Credit Conversion Factor (CCFL) than 50% should apply.

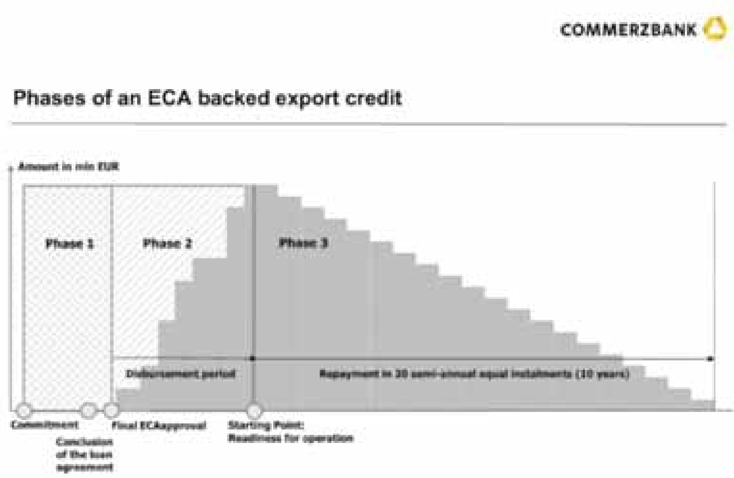
***Phase 2: ECA approval to disbursement***
Similar to phase 1, a CCFL of 50 % ignores that an ECA-backed export credit is not easily disbursed in a stress scenario. Disbursements are always linked to the presentation of shipping documents/service certificates. Therefore, a natural hurdle is raised to prevent parties from receiving instant disbursement. Such period may last two to three years, even on some occasions, up to five years.

***Phase 3: disbursement to final repayment***
During the lifetime of the loan (up to 18 years according to OECD sector understandings) the LR will be applicable. At present, the additional equity consumption resulting from such a leverage ratio seems to be the major threat to more accurate business predictability. Any a hurdle will be seen as a potential showstopper for a deal.

### The EBA has opened a door for ECA-backed export credits in Europe

In early August, the EBA published its long awaited report on the impact of the leverage ratio on the finance industry ("*EBA report on the leverage ratio requirements under article 511 of the CRR*"). Even if it is not that easy for practitioners to obtain the substance of the comprehensive report, it can be seen as an important milestone on the way to

**Graph 3: how an ECA deal is affected by regulation**



**Graph 4: front page of the EBA report**


implementing a leverage ratio in Europe and for improved understanding of how resilient the various business segments of financial institutions are in light of the new regulation. The EBA's assessment is based on various discussions with industry experts, business associations and on statistics and quantitative analysis. In order to share this assessment with the industry the above were invited to a public hearing in April 2016 where over a 100 participants from all areas of the financial sector, including representatives of the ICC, Berne Union, ECAs and EBF, attended.

During the hearing many issues were brought to the attention of the EBA. It was argued that the consequences of the implementation of the leverage ratio should be carefully assessed in the context of product specifics, validation of collaterals/guarantees, support for SMEs and also for trade and export finance.

The report will now form the basis of further work by the European Commission on a potential legislative recommendation for a leverage ratio minimum requirement in the European Union. It is not considered surprising that the EBA deems the potential impact of introducing a leverage ratio requirement of 3% on the provision of financing by credit institutions, as a whole, to be relatively moderate. From an EBA perspective such a leverage ratio should lead to more stable credit institutions and help mitigate the risk of excessive leverage.

The EBA comments that "the results of the quantitative analysis performed, suggest that a 3% level of calibration for the LR is, generally consistent with the objective of a backstop measure which supplements risk-based capital requirements."

At the same time, "the results of a simulation-based analysis, estimating the impact of potential adjustment actions [...] suggest a high sensitivity to changes in the calibration of the LR and estimate that the potential reduction of exposures would increase significantly beyond a LR level of 3.5%."*

Based on the EBA report it can be expected that a 3% leverage ratio will be introduced into Europe. And yet the acute concern of the industry that a more restrictive ratio might be determined at a higher level of 4% or 5% is still there and will still be a further potential threat for the Global Systemically Important Institutions (GSIIs).

In order to understand the EBA's view on the mechanism of such a leverage ratio it is interesting to refer to the report again: "Hence, the LR and the risk-based capital requirements should function in a complementary manner, with the LR defining a minimum capital to total exposure requirement and the risk-based capital ratios

**There are also strong indicators that the adoption of Basel III regulation within banks can be seen as a negative catalyst especially for ECA-backed export credits. The ECA business in Asia is dominated by public banks and not bound to regulation. Other major growing ECAs located in non-OECD countries are also exempt from harsh banking regulations.**

**Graph 5: excerpt from EBA report, p.198**

**6.4 Specific characteristics of ECA financing**

One category of trade finance exposures is those guaranteed by state-backed ECAs. ECA financing (as also discussed in section 6.9 of the NSFR report) serves the purpose of providing credit protection or, in some cases, direct financing (along with other primary lenders) for projects or export transactions. In 2015, the total commitments of European ECAs at year end amounted to $330 billion, of which 0.04% consists of direct financing. ECA instruments include guarantees, credit insurance and loans provided to foster the manufacturing and export of goods.

It is also noteworthy that an ECA-covered transaction (before being fully on balance sheet) is usually committed from the first day the transaction is made, although the payout happens over time. It is understood that this initial phase can easily take two to three years, during which time a CCF of 50% applies to the commitment for the purposes of the LR calculation (given the long-term nature of these transactions the original maturity is greater than one year).

The type of risk protection can vary. ECAs usually cover the political risk in a high proportion and also cover commercial risks.

The percentage taken into account for a comprehensive cover is the minimum percentage covered under political risk and commercial risk. It should be noted that there are additional technical differences between insurance and guarantees which may impact the level of coverage and the mechanisms to trigger and collect a claim. The protection provided by an ECA not only extends to principal payments but also to interest payments due under the transaction.

limiting risk-taking. In order to achieve this, and considering the role of the LR as a supplementary measure to risk-based capital requirements, calibration needs to be determined in a manner which ensures that both approaches to capital regulation remain relevant."**

From an EBA perspective the leverage ratio serves as the minimum level for a bank's source to cover losses. For riskier business additional equity is needed but the major concern of the EBA is related to low-risk profile business with a higher leverage.

As a result, it is of major importance that the EBA report came to the conclusion that "an exception may be ECA-backed exposures, which may, in some cases, have a risk weight as low as 0%. Given the lack of data on these exposures, it cannot be excluded that if some institutions are specifically constrained or bound by the LR, an incentive may be created not to expand/reduce their exposure to this category."***

Not only have ECA-backed export credits arrived on the radar of EBA, they have also been acknowledged as a potentially constrained business (see Graph 5).

The EBA comes to the overall conclusion that "one exemption may be ECA-backed exposures, which typically attract a very low-risk profile"****. From my perspective this conclusion opens the door to further discussions, supported, I would hope, by the export-oriented industry in Europe as well. I am confident that other regulators (BCBS, WTO, EU COM, ECB) will rapidly realise the situation and understand the need to protect trade and export finance (and high-profile jobs) during turbulent times.

## The way ahead

The EBA expressed the critical need to exempt a certain business segment from the leverage ratio on several occasions. What is more, market participants admitted that the ratio should be kept as simple as possible and the envisaged regime of a 3% minimum leverage ratio appears reasonable. Given the overall impression of regulators (and citizens at large) that leverage in banks should be restricted, the foreseen ratio of 3% will highly likely become the standard. This said, discussions with the regulators should continue, based on a wider understanding of the transaction specifics of ECA-backed export credits to define which mitigants could be brought to banks willing to offer export credits. One of the lessons learned from previous hearings, meetings and discussions was this: a joint effort by the Berne Union, ICC, EBF and business associations may help to address the major concerns of the export industry. And exporters should be more vocal and active in these discussions, to express their needs for export finance supported by commercial banks. ■

**Notes**

* page 15, EBA report on the leverage ratio requirements under article 511 of the CRR

** page 12, EBA report on the leverage ratio requirements under article 511 of the CRR

*** page 25/26, EBA report on the leverage ratio requirements under article 511 of the CRR

**** page 200, EBA report on the leverage ratio requirements under article 511 of the CRR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EXPERT ANALYSIS

# Funding products and guarantees: The Credendo experience

**By Paul Becue, technical communication specialist, Delcredere | Ducroire**

In the last few years, Delcredere | Ducroire, the parent company of Credendo Group, has launched various initiatives to support the financing of Belgian export operations. First of all, there's the direct financing of SMEs by way of forfaiting and the buyer credit, as a suppletive product to fill in the gap in the market. Besides these two direct financing tools, there are several indirect financing instruments. Credendo thus stimulates bank financing of exporters through its financial guarantees. Furthermore, there's the Credendo financial guarantee for private bond issues, besides the possibility of using Credendo policies in covered bonds of banks. Finally, there is the export funding guarantee.

## Forfaiting

In 2004 Credendo started offering 'forfaiting' as a financing product for (relatively) small credits from two to five years which Belgian exporters offered to their foreign buyers ('supplier credit'). It was launched as a 'suppletive product', meant to fill in the gap left by the commercial banks. A supplier credit means that the exporter itself prefinances the contract and production, and grants its buyer the credit. This credit is materialised in bills of exchange or promissory notes. Forfaiting means that Credendo is discounting these bills of exchange or promissory notes, i.e. buys them from the exporter. It is thus an indirect financing of the buyer. This financing product was created to be used in parallel with the credit insurance product that covers the non-payment and termination risk for the exporter. SMEs are clearly the main target for the forfaiting product. Since the launch of the forfaiting product, Credendo has several times enlarged its scope, increased the capacity provided and made its terms and conditions more flexible in order to meet as much as possible the exporters' needs.


Paul Becue

## Buyer credit

Credendo further increased its efforts to facilitate export financing for SMEs. This is aligned with the strategy of the Belgian government which stressed the importance to support SMEs going abroad. Early 2016, Credendo launched a new financing product, the buyer credit. Under this new product, Credendo will be granting the financing directly to a foreign buyer of Belgian goods and services. After delivery and presentation of the necessary documents to Credendo, the exporter will be paid by Credendo, in the same way as he would be under a buyer credit granted by a bank. The foreign buyer will reimburse the credit over two to five years. The credit amounts considered are between €2 million and €5 million. The exporter has to enter into a credit insurance policy with Credendo to cover its termination risk under the commercial contract.

For both financing products, the OECD Arrangement applies. In addition to the new financing instruments, Credendo has also launched a specific SME desk to offer a more comprehensive service to SMEs. On the business development side as well, efforts have been made to attract more SMEs.

### Financial guarantees for bank credits

Credendo can participate in credits that a Belgian company needs for its trade transactions. Banks consider Credendo as an attractive partner thanks to its credit rating (AA with S&P). There are three kinds of credit facilities which each have a different purpose:

- the issuing of bank bonds (bid bonds, advance payment bonds, performance bonds, etc.);
- the financing of a company's working capital;
- the financing of investments abroad (buildings, machinery, equipment).

A link with the company's international business is always compulsory. The target is clearly to promote Belgian export trade.

### Support for bond issues

Credendo can assist a Belgian company and bank in finding additional funds for bond issues on capital markets. This support can appear in two ways.

The first is a financial guarantee by Credendo in favour of investors who are willing to subscribe to a privately contracted bond issue (not via public markets). The bond is issued by a Belgian business with international operations, and it covers its payment obligations in favour of the bondholders or their trustees (acting as a proxy for the bondholders). In principle, 50% of the bond amount is guaranteed.

Another recent development concerns the covered bonds. After the subprime credit crisis of 2008, securitisation was no longer evident due to a crisis of confidence. But the Belgian law of 3 August 2012 made the issue of Belgian covered bonds possible. Only banks accredited by the Belgian central bank can issue them on the public markets. The law foresees that these bonds are covered by several debt categories, for example mortgage loans. Another coverage possibility is offered by debt claims on or guaranteed/insured by public institutions. And this is where can Credendo intervene: Credendo's insurance policies in favour of the bank were recognised by the Belgian central bank as an asset which can be pledged for the covered bond issue. But of course, this depends on the bank. Up until now it hasn't been used yet as there is enough liquidity.

### Export funding guarantee

Credendo has another product that can help banks to finance large amounts in export transactions, i.e. the export funding guarantee. The purpose is to facilitate the financing of Belgian export transactions by providing banks with access to funding at more competitive conditions, hereby contributing to solving the liquidity cost issue that commercial banks (and in particular European banks) faced in the aftermath of the financial crisis. Banks that finance an export credit with Credendo's insurance can refinance themselves with external investors

**Credendo has taken a lot of initiatives to stimulate the Belgian export financing in the last ten years, targeting in the first place the SMEs. All these initiatives should have a positive stimulating effect on the Belgian economy.**

based upon a 100% guarantee by Credendo. It's an unconditional guarantee on first demand that can be called by the investor if the bank, for whatever reason, does not reimburse at maturity. The aim is also to indirectly provide cheaper funding to Belgian exporters. However, the product has not been used up until now since the liquidity situation of most banks has improved.

### Conclusion

The examples above show that Credendo has taken a lot of initiatives to stimulate the Belgian export financing in the last ten years, targeting in the first place the SMEs. All these initiatives should have a positive stimulating effect on the Belgian economy. ■

**In addition to the new financing instruments, Credendo has also launched a specific SME desk to offer a more comprehensive service to SMEs.**

EXPERT ANALYSIS

# The ICC & export finance: An update on key developments

**By Eric de Jonge, managing director, global head structured export finance, ING Bank, and David Bischoff, policy manager, Banking Commission, ICC**

A year after the first meeting of the ICC Export Finance Committee in Barcelona it is a good time to look back at what we had in mind starting this initiative and where we stand now.

Over the last months we received quite a few inquiries related to this committee, varying from questions related to what the committee is about, to whether it would be possible to join. We were also pleased to receive invitations to present ourselves at various conferences.

Looking back at the start when receiving the approval of the ICC banking Commission, the purpose of launching this committee was threefold:

1. To create a credible standing global discussion forum of banking experts in medium and long-term (MLT export financing;

2. To create a representative body to discuss industry matters with various stakeholders;

3. To advocate for and help develop improvements and efficiencies through the standardisation and harmonisation of processes and regulations.

Following the earlier successful initiative of the ICC to include medium and long-term export covered financing in the ICC Trade Register Report, we were pleased with the ICC Banking Commission welcoming this initiative to further help this global industry to provide for a platform under its global umbrella. The warm welcome was best illustrated by the words of Daniel Schmand, the chair of the ICC Banking Commission:

"The export industry is by nature a global industry and the committee is therefore also truly global – connecting with, and gleaning information from, key institutions around the world that serve the export finance business. The hope is that the forum will become a global representative body in discussions with all kind of stakeholders – representing an industry that may be small, but is certainly crucial."

Eric de Jonge

David Bischoff

Since the export finance industry is indeed global, the first goal was to form a committee with industry experts from all continents with not only the biggest banks being represented. Based on the initial inquiry, feedback was positive from many people to join and volunteer to try and bring this industry to a next, higher level. Jointly with the ICC, 14 members were selected to get this going. This also meant we had to disappoint a number of people later on given the already large size of the committee. The terms of reference however provide for the possibility for other experts of other banks to join when existing members step down after a three year period. It is certainly not envisaged that when a member leaves, another person of that bank will take over. The ICC will also ensure that the committee remains truly global and that its members are also truly active.

The second goal was to quickly liaise with our most important partners in the industry, the export credit agencies (ECAs). This purpose was best served by connecting with the Berne Union, the representative body of Export Credit Agencies and Private Insurers. Its Secretary General Kai Preugschat wholeheartedly supported the idea from the start and the Berne Union formed a working group from its medium and long-term Business membership to get the ball rolling.

The third goal was to start with an agenda of items that the industry is facing and where some immediate action would be required.

**The export industry is by nature a global industry and the Committee is therefore also truly global - connecting with, and gleaning information from, key institutions around the world that serve the export finance business**

Our kick-off meeting in Barcelona last year served that purpose and a few main topics were listed.

So, were do we stand one year after the inception?

Like the export finance business, nothing really moves very quickly. Sometimes unfortunately. There are however a number of encouraging achievements and developments, which we would like to reflect on.

First, we did have our first physical meeting with the sub-committees of the Export Finance Committee and the Berne Union. A number of industry topics have been discussed and an action list was formed. This is a historical step, which was received with enthusiasm from both sides. Some further follow up already helped in solving certain issues between parties form both sides.

The second meeting will be held in Lisbon end of October, illustrating this initiative is useful and here to stay.

Secondly, we focused on a number of topics related to the consequences of changes in regulations following Basel 3 and 4.

Two main topics were formulated in order to ensure further follow up:

1. The impact of the leverage ratio, potentially threatening the export finance industry due to higher capital charges, requiring much higher pricing;

2. Art 194 of the CRR (Capital Requirements Regulation), embedding in European law the need for legal opinions on risk mitigating instruments to ensure reduction of RWA (Risk Weighted Assets).

The first topic requires ongoing discussions with all stakeholders in the industry. A higher capital charge, unrelated to the well mitigated underlying risks in this industry is unwanted and odd when thinking of governments stimulating the very same industry that will be impacted by their consent to such regulation.

The various efforts by amongst others the EBF have at the minimum resulted in some attention for the impact of the leverage ratio on the Export Finance Industry. In its report on calibration on the leverage ratio (LR), the EBA stated: "An exception may be export credit agency (ECA)-backed exposures, which may, in some cases, have a risk weight as low as 0%. Given the lack of data on these exposures, it cannot be excluded that, for some institutions, if they would be specifically constrained or bound by the LR, an incentive may be created not to expand/reduce its exposure to this category."

It is furthermore understood that the European Commission will want to avoid any negative impact on trade. At the time of writing this, the EBF, the ICC Export Finance Committee as well a few industry experts are exchanging thoughts in order to provide for further feedback to try and get some form of relief for this industry in the coming LR regulation.

The second topic has been put on the agenda to come to some form of standard approach for the industry, as per the suggestion of the members of this committee. It is unwanted that all financial institutions would need to make high costs to meet this requirement, where a joint approach and a guideline would be more efficient and cheaper.

At this point in time a number of financial institutions have catered for external general legal opinions on various products of the ECAs, some of which are for the benefit of all institutions using these products. Unfortunately, some of these opinions are only written for the benefit of those that have paid for the opinion.

Then there are the ECAs for which there are no such opinions yet, while for some ECAs there is a standard market approach to cater for a specific legal opinion per transaction.

There is also the ongoing issue of future monitoring to see to it that the opinions still cover the fact that the underlying ECA covers are still legally valid and binding.

The Export Finance Committee intends to come with a further elaboration on this topic in the coming period, to serve the industry with a standard approach to create awareness and (cost) efficiencies.

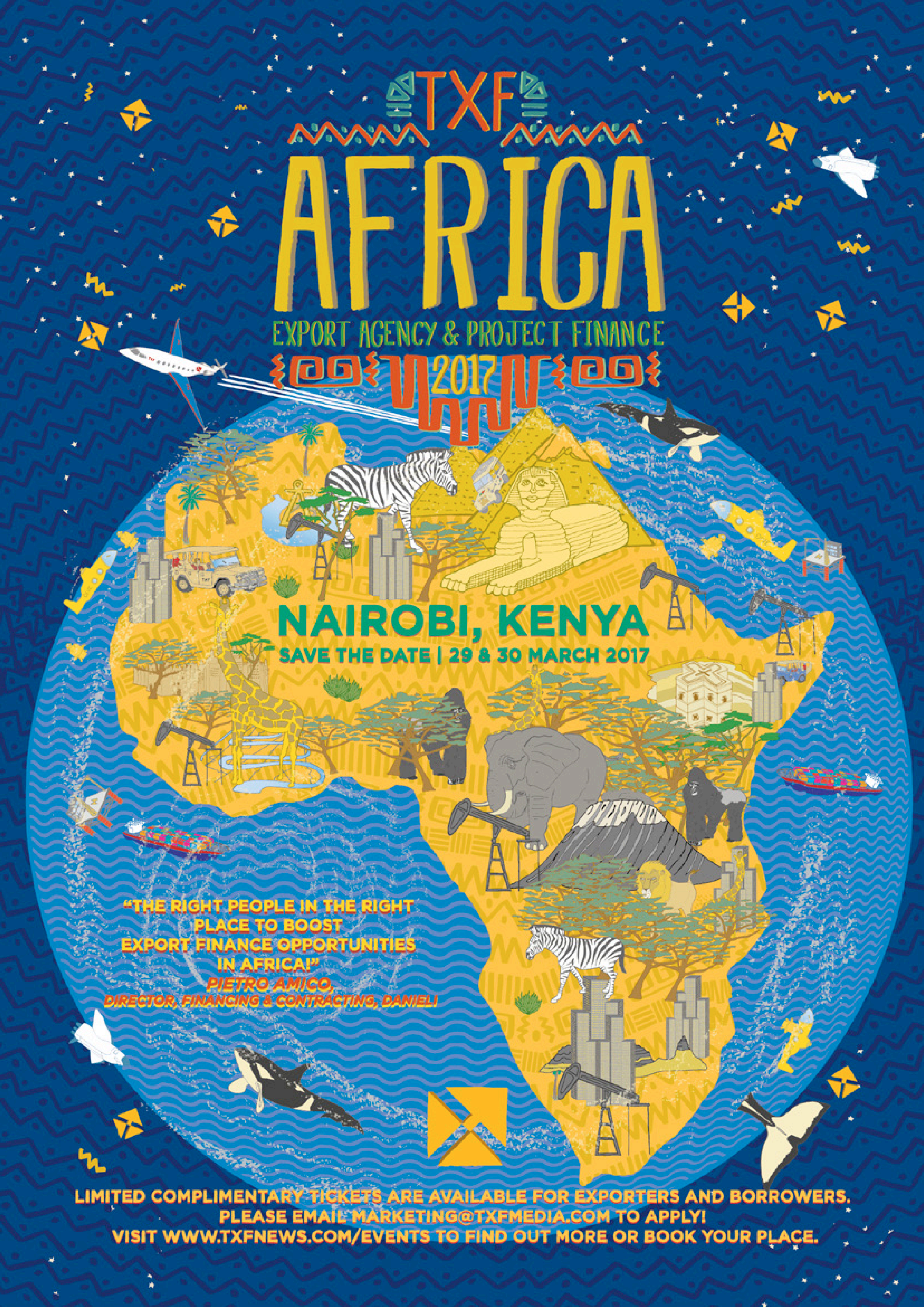
And thirdly we formed an agenda and action list going forward, to be discussed in conference calls and at physical meetings of the committee, mostly planned around large industry events/conferences.

**The overall guiding principle remains and that is to foster for a better and more efficient industry over time.**

The objective for our committee is certainly not to cover what other stakeholders like the EBF and BAFT etc. are doing already. It is the intention to coordinate and act on behalf of the global industry.

The overall guiding principle remains and that is to foster for a better and more efficient industry over time. This can only be done by being fully transparent in what we do and by involving the whole industry in what we should be doing.

Therefore, we most welcome further initiatives and suggestions to bring this industry to the next level. ■



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# The economist's view: A world caught in tradelock

**By Mahamoud Islam, senior economist for Asia, Daniela Ordoñez, senior economist for Latin America, and Ludovic Subran, chief economist, Euler Hermes**

Global trade was high on the agenda of the G20 meeting in Hangzhou, China – and for a good reason, too.

Volume growth trudged along at a limited pace over the past four years, twice slower and twice closer to GDP growth rate when compared to the pre-crisis period. In 2016, it might even dip below the key overall indicator. Trade volume growth is expected to reach +2.1% against GDP growth of +2.4%.

Unsurprisingly, such trends raise worries among the leaders of major economies. Global GDP has been inching up below 3% since 2012 and trade seems to be one of the culprits. In the pre-crisis period, strong expansion in global movement of goods and services was associated with healthy economic growth and a fast catch-up by emerging markets.

Against this backdrop, G20 members with China as a frontrunner called for further coordination and action. Their aim, if you will, was to rid the global economy of what I call tradelock. In this situation sluggish trade hinders growth and vice versa.

Solemn pledges to act might suffice for some pundits. Those who want to believe are welcome to. Reality as seen through the economist's lens is, sadly, a trifle more complex.

There are few reasons to believe in a fast recovery. Real global trade would likely grow below 4% in the medium term, far below the pre-crisis average of 7%.

## Stuck in the slow lane

Global trade growth in volume will slow in 2016 to 2.1%, down from 3.0% in 2015. In value terms, it should contract at a slower pace: -2.9% this year, after -10.4% in 2015. Why is this happening? Look no further than low

**Mahamoud Islam**

**Daniela Ordoñez**

**Ludovic Subran**

commodity prices, which push down overall prices.

Currency depreciation and volatility will also remain a drag. These reflect the continued divergence in monetary policy between the US and large economies such as China and the Eurozone. While the former is tightening, the latter is easing. Add to those ongoing concerns over large emerging markets such as Russia, Brazil. When these engines sputter, if not overall choke, the whole machine is stuck in tradelock.

We see a slight improvement next year, with volume trade expanding by a modest 3.1% in 2017. In value terms, USD denominated trade growth would rebound (+5.7%) due to progressive improvement in commodity prices and less currency depreciations.

What's crucial is that global demand growth would finally improve. Demand from advanced economies could strengthen. Expect firm growth in the Eurozone and gradual improvement in Japan as policymakers intensify their support.

Demand from emerging markets should also expand somewhat as Russia and Brazil will exit recession. China's imports would see a significant rebound next year as policy stimulus continues. Add to the mix a growing middle class, which translates into services imports such as tourism, and education related expenditures. Higher demand growth would help stabilise global prices. As the same time, better prospects outside the U.S. will translate in lower pressures on currencies.

**Small pie, small gains**

In this context, countries will find it hard to grow through exports.

Core Eurozone countries and markets related to their value chain such as Romania and Poland would top the league. These economies combine real exports growth which is well above global average with a rise in market share over 2016-17. They will benefit from a heady mixture of cheap currency, eased financing conditions and improved demand growth by main partners (namely European Union members). Next in line will be countries with strong competitive advantages. Vietnam, Philippines, Morocco, and Kenya are all good examples of economies benefiting from cheap labour costs and strategic positioning in regional value chains.

Second, a weaker RMB in China will provide some boost to volume growth. Yet one can expect reduced US dollar exports gains (+$33 billion only from 2015 to 2017) and a loss of market share (-0.15pp). Causes include a deteriorated price competiveness over the ten past years (due to rising wages and strong appreciation of the RMB) and limited demand overseas. For net primary industrial producers, countries with strong market share (e.g. Saudi Arabia, Australia, and South Africa) or more diversified export base (Canada, Mexico) may enjoy strong growth in volume terms. Yet market shares will probably decline with a lack of a price boost. For manufacturing hubs such as Turkey and Thailand, weaker currencies will lead to lower USD denominated exports. Then upside of depreciations is a boost to volume growth.

The main losers would include: (i) countries highly dependent on Chinese demand (primary industrial commodities and Asian trade suppliers), (ii) exporters suffering from monetary tightening or strong currency (United States), (iii) markets that are affected by political deadlocks (Russia).

**With global trade of goods growing below trend, companies need to find alternative strategies to internationalise. Recent trends offer a few ways forward.**

**Low for longer?**

In the medium term, there are few reasons to expect a significant upturn. Global trade is hampered by frequent demand shocks, structural adjustments in the global value chains, lack of US dollar financing, competitive depreciations and political hurdles.

***Brake #1: demand shocks become more frequent***

Global demand is struggling to find a solid footing as cyclical shocks become more frequent. 2015 marked the fourth consecutive year in which GDP growth has been below the +3% threshold. This situation might last until 2017 at least.

The Eurozone crisis and austerity policies were the main culprits in 2012-2013. Since then, headwinds in the emerging markets have been the main drag. Heightened financial volatility, weaknesses in some large emerging markets, increasing signs of a bumpy transition in China, and low commodity prices hit oil producing countries are all to blame.

**Currency depreciation and volatility will also remain a drag. These reflect the continued divergence in monetary policy between the U.S. and large economies such as China and the Eurozone. While the former is tightening, the latter is easing.**

***Brake #2: Structural adjustments are still underway***

Structural adjustments in global demand components and value chains are still underway. In particular, lower investment translates into lower import growth while vertical integration of large economies affects global supply chains.

The main protagonist of these changes is China.

Growth pivots from a reliance on investment, exports, and manufacturing, to consumption and services. This also means a shift from the production of low value-added goods to high-tech products. On top of that, there is also a will for a more sustainable growth which is less resource and credit intensive.

Lower investment growth and economic servitization will translate into weaker demand for basic materials and capital goods.

The upgrade of the economy is associated with substitution effects where domestic companies rely more on local suppliers than foreign ones. Asian economies will bear some of the brunt. Old trade hubs partners (e.g. Hong Kong, Taiwan, Singapore) and industrial commodities suppliers (Malaysia, Indonesia, Australia) are the most affected.

***Brake #3: US dollar shortage renders external payments difficult***

Limited access to US dollars makes it more difficult to pay for imported goods. For some countries, the problem could persist. Further monetary policy tightening by the Fed means that worldwide liquidity would continue to decrease. And when the world's currency runs low so do external payments and trade flows.

## The impact of low commodity prices on commodity supply chains

***Jean-François Lambert, founding partner, Lambert Commodities***

**Jean-François Lambert**

After an exuberant supercycle, have we entered into a period of secular stagnation of commodity prices? If so, what are the consequences of this 'new normal' for all actors on the commodity supply chains?

Indeed, the supercycle is now well over. 2015 witnessed a major commodity rout, affecting all sectors. 2016 raised hope after the sharp rebound of commodity prices in the first half. Its sustainability is not warranted though, as the world economy seems to have entered in the prolonged low growth era.

Yet, all is not gloom and doom, and China is still displaying a robust appetite for commodities.

Translated into flat prices, the worst of the rout should be over. However, a sustainable rebound of prices is unlikely: volatility will therefore remain high.

What does this mean for commodity supply chains?

- Producers have faced a difficult environment and, while markets have improved, the remainder of 2016 is unlikely to provide great comfort to them.
- Traders are much better off. Volatility is their garden and they are less affected by flat price movements than producers. Besides, their liquidity requirements are lower in the current market and are bound to remain stable. Good news for an industry which relies so much on bank finance.
- What is good for traders is not necessarily so for bankers:
  - The consequence for low commodity prices is a low utilisation of their facilities, hence lower profits. Not great for an industry already challenged by ever more demanding capital requirements and negative or low interest rates.
  - Risk, on the other hand, should remain under check – at least as far as traders are concerned, while producers' (and processors') risks remain to be monitored closely.
  - Banks will compete for more utilization and this could weigh on spreads, although it should not push them too far down as return on capital remains the prime concern for this industry.

Overall, a mixed bag. Commodity supply chains and their financiers would certainly benefit from a less uncertain environment. Arguably, nothing last forever. But at least for the years to come, it seems that this very uncertainty could have become a 'new normal' to which all parties should get accustomed.

Second round effects may take place and capital outflows are a particular worry. Lower FX reserves translate into a more prudent monetary policy stance from Central Banks as governors become reluctant to share with the private sector. This is a typical problem in small emerging markets such as Papua New Guinea and Mongolia but also for larger markets such as Venezuela and Nigeria.

***Brake #4: Unproductive currency depreciations***

In theory, a decrease in the value of currency can be supportive for exports. Once more, reality bites – and crawls. Simultaneous competitive depreciation is a hurdle for trade, and even more so when global demand growth is low.

The past two years showed that depreciation works best when implemented in markets with improved financing conditions and little reliance on industrial commodities. For such economies, cheaper currencies may translate into better price competitiveness. This should lead to an increase in export volumes.

In contrast, countries suffering from forced depreciation due to capital outflows and weaker domestic financing condition (tightened monetary policy) may suffer. This is especially true for those which rely on primary commodities. In this case, the main effect of currency depreciation is a contraction of imports. This is the case for Latin American, African, primary industrial commodities exporters in Asia.

***Brake #5: Political hotspots and protectionism***

Political hotspots continue to weigh on traders' confidence, driving countries and multinationals to take a wait and see position. Soured relations between the West and Russia, risks of conflict in the Middle East with the collapse of Yemen's government, and political instability in Syria are all clear examples. In Brazil and South Africa discontent is on the rise as a result of

## The impact of low commodity prices on ECA financing

***Clarine Stenfert, global head of infrastructure export finance, JP Morgan***

Clarine Stenfert

Low commodity prices have impacted export finance, but what is interesting is not so much the reduction in volumes, but the resulting shifts in the marketplace that we have seen over the past 12 to 24 months.

TXF's statistics show that global ECA volumes dropped by nearly a third from 2014 to 2015 and the data for 2016 YTD suggests that, whilst ECA financing has typically been cyclical, we are unlikely to see a recovery this year.

In some sectors such as oil & gas and metals & mining, with many of these are structured on a non- or limited recourse basis, we have seen some projects delayed largely due to a reduction in cashflow forecasts. The issue has been compounded in commodity-rich markets where the impact on economic growth has also led to public sector projects being postponed. However, for areas where infrastructure projects are proceeding, we are now seeing sophisticated entrants to the ECA financing market that were traditionally cash players, seeking alternative forms of financing.

Moreover, in sectors where commodities are a cost rather than a revenue item, continued low prices are having a direct but beneficial impact to the bottom line for borrowers. Power projects are continuing apace, particularly those fired by fossil fuels, and now comprise the largest sector in export finance. Aviation is also currently benefitting from the low oil price environment with the boost to airline financials attracting new liquidity to the sector.

The increase in commercial liquidity has not been restricted to aviation. Asian DFIs, in particular the Chinese policy banks, have become major players in energy and infrastructure projects, for example.

While low commodity prices have resulted in a reduction in ECA volumes, if the low price environment continues, we expect to see a wider spectrum of ECA borrowers active in the market going forward. As cashflow expectations adjust, buyers will look for new financing opportunities to fund their strategic imports.

deteriorating economic prospects and rampant unemployment.

The rise of protectionism is also a major obstacle. This is true for explicit trade barriers such as high tariffs (e.g. India or Brazil) as well as less direct measures such as subsidies (e.g. France with its public bank). A top 10 list of protectionist countries since 2014, is dominated by emerging markets with the BRICS leading the wat. However, the US, Japan and the UK have also been quite aggressive in restoring protectionist measures.

## External growth alternatives: meet EDI

With global trade of goods growing below trend, companies need to find alternative strategies to internationalise. Recent trends offer a few ways forward.

First, businesses can leverage Foreign Direct Investment (FDI) to get closer to consumers and then repatriate investment revenues. The nature of current economic growth calls for further proximity as consumer demand and services are becoming the main growth drivers globally. Households' consumption accounted for 61% of GDP in 2015, up from 58.3% GDP in 2014.

Moreover, a currency valuation effect is still in play. Countries where there was little depreciation since 2014 lost price competitiveness but gained purchasing power (e.g. USD, JPY). Cash rich companies can venture abroad and buy assets on the cheap.

Finally, countries with large current account surplus and mild economic prospects (e.g. Taiwan, South Korea) can use foreign investment as a way to recycle savings.

A second way forward is, well, to really move forward. Companies must adapt to new drivers such as digital flows and services. Trade in the latter has been less disrupted compared to goods trade. In 2015, services exports accounted for 6.7% of global GDP (stable from 2014), while exports of goods decreased to 22% (from 24%).

Looking ahead, there are signs of further improvement. A gradual recovery in oil prices would be associated with an improvement in marine transports services and a modest pickup in global demand. Structurally, this will be underpinned by the servitisation of large emerging markets like China.

Another type of cross-border movement is growing rapidly: data flows. Digitalisation of business activities contributes up to 9.4% of the annual global economic output, according to estimates by Euler Hermes. This figure is set to reach 16.6% in 2020.

However, only affluent countries and advanced markets benefit from the transition to knowledge-intensive economy. These typically have the necessary infrastructure to enable fast access to the internet and other technological networks.

To asses readiness for change Euler Hermes developed a proprietary Enabling Digitalization Index (EDI). It grades 135 countries on a scale based on the quality of connectivity, logistic performance and ease of doing business.

EDI's scores show a clear discrepancy between advanced economies and emerging markets. Germany, the Netherlands and Sweden lead the ranking. None of the BRICS rank in the top 40 and China ranks 44th. While it performs relatively well on logistics sub-indicator (24th out of 135 countries), the Asian giant still lags in connectivity quality and ease of doing business.

Third, companies can take advantage of mega trade agreements. Despite political resistance and protracted haggling international deals are potential game changers. So where do things stand? The adoption of the Transatlantic Trade and Investment Partnership is blocked since France and Germany have threatened to withdraw from negotiations. The US elections could also be pivotal for the Trans Pacific Partnership. The One Belt One Road designed by China seems to be on more solid ground. However, implementation would take time. So far, no formal treaty has been negotiated between the 65 participant countries. ■

**Looking ahead, there are signs of further improvement. A gradual recovery in oil prices would be associated with an improvement in marine transports services and a modest pickup in global demand. Structurally, this will be underpinned by the servitization of large emerging markets like China.**

EXPERT ANALYSIS

# The oil price hardly matters for Russian country risk

By John Lorié, Theo Smid and Pieter Sayer[1], Arradins Credit Insurance

## 1. Introduction

The Russian economy is in a recession. Russia's GDP contracted by 3.7% in 2015 and is forecast to contract again this year. With oil and gas accounting for 70% of Russian exports, the recent oil price decline is one reason behind the economic turmoil. The sanctions imposed against Russia since Q1 of 2014 by, amongst others, the US, Canada, Australia and EU countries, is another one. For 2017, GDP recovery of 0.8% is expected as domestic demand slowly picks up.

This article focusses not so much on an analysis of the economic perils of Russia. That is already widely covered by others. Rather, we put ourselves in the shoes of businesses trading with or investing in the country. We want to establish empirically the impact of the oil price decline on the risk of doing business in Russia. Indeed, we focus on the impact on Russian country risk, using the empirical tool of correlation analysis.

Literature on the relationship between oil and country risk tends to focus on the political side – factors such as corruption and rent seeking. A number of studies find a positive relationship between oil and corruption.[2] There is also evidence of a negative relationship between oil revenues and political rights and a positive correlation with civil liberties. The idea is that oil states repress political rights in order to prevent the masses from getting a share of the pie, but have to give civil liberties in return keep people satisfied. However, there are also studies that do not find any effect of natural resource abundance and the degree of corruption.[3]

One of the difficulties with this type of research is that it is hard to prove causality between natural resources and the political climate based on regression techniques that primarily exploit variance between countries. Moreover, there is a perceived probability that the results suffer from omission of relevant variables that are time-invariant and country specific, causing omitted variable bias in the estimates. We will see that our approach provides comfort for the causality issue whilst omitted variable bias is ignored by nature of the empirical tool. The latter indeed provides the caveat to our results.

## 2. Data and methodology

We use the Euromoney Country Risk (ECR) score to measure country risk.[4] ECR provides an online rating community of economic and political experts. The overall ECR score provides a snapshot of country risk in a country on a 100 point scale, with 100 being nearly devoid of any risk, and 0 being completely exposed to every risk. The headline ECR score is built up of six categories (which in total consist of 18 subcomponents). Three of the categories are qualitative expert opinions on political risk (weighting 30%), economic performance (30%) and structural assessment (10%). The other three quantitative scores are debt indicators (10%), credit ratings (10%) and access to finance/capital markets (10%).[5] An overview can be found in Appendix Table A1.

We plot the development of the oil price and the ECR score in figure 1. Casual inspection suggests a correlation between the two. But one should be careful: a closer look reveals that the relation is far from perfect. For example, when international sanctions were imposed against Russia in mid-2014 the CR score fell significantly as the

**Figure 1**
**Oil price (in US$) and Euromoney country risk score**


Sources: Euromoney, IHS, Atradius

oil price hardly budged.

We use a dataset provided by Euromoney for the overall ECR score as well as scores for the different categories and subcomponents over the period 2011 Q1 – 2016 Q1 for Russia. Quarterly data are used. Oil prices are collected for the same period from IHS and are converted into real prices, with 2014 as a base year.[6] Our dataset gives us 22 observations for the overall ECR score and its category scores.

We use correlation analysis to link the oil price to ECR scores. This is purely a function of data limitations. A regression of ECR on the oil price and controlling for relevant variables would have been better. But it turns out the regression coefficients are hard to interpret given the low number of observations.[7]

Correlation coefficients as such describe a two-way relationship between variables, meaning that causality does not become evident from the coefficients themselves. However, Russia can hardly exert any influence on the oil price, which is determined in the global market. Russia is simply a price taker in that market. Therefore, if a significant correlation is found, there is a strong case to be made that the causality runs from the oil price to the ECR score. We are simply less concerned with the causality issue. Moreover, we address the underlying trend in the ECR scores and oil price that is observed in Figure 1 by taking first differences. It reduces the number of observations to 21, though.

An assumption we make is that ECR scores are collected uniformly throughout each quarter. Based on the information provided by Euromoney, which stresses that the ECR scores provide a snapshot of a country's current position, this seems a plausible assumption. We therefore also take the average oil price during each period. In an attempt to control for the sanctions against Russia that are in place since 2014 Q1, we have also calculated the correlations pre and post sanctions.[8] The downside is that this further reduces the number of observations to 12 for the pre sanction period (2011 Q2 – 2014 Q1) and nine for the post sanction period (2014 Q2 – 2016 Q2).

## 3. Results

Estimation results can be found in Table 1 for the three main categories underlying the ECR score: economic, political and structural risk. Correlation coefficients between the oil price and the overall ECR score and the scores on the categories economic, political and structural are all found to be positive when looking at the full sample. The correlation coefficient of the economic score is found to be significant, whereas the political and structural scores are not. This makes sense given that the negative effects from the low oil price on the Russian economy is obvious, whereas the empirical evidence on the effect

**Table 1 Estimation results**

| Risk category | Full period | | Pre-sanctions | | Post-sanctions | | Difference |
|---|---|---|---|---|---|---|---|
| | Correlation | p-value | Correlation | p-value | Correlation | p-value | p-value |
| Economic | 0.686*** | 0 | 0.51* | 0.09 | 0.797** | 0.01 | 0.32 |
| Political | 0.093 | 0.69 | 0.187 | 0.56 | 0.165 | 0.67 | 0.97 |
| Structural | 0.139 | 0.55 | -0.188 | 0.56 | 0.484 | 0.19 | 0.17 |
| **Overall score** | **0.238** | **0.3** | **0.204** | **0.52** | **0.01** | **0.8** | **0.84** |

* Significantly different from zero at 90% level
** Significantly different from zero at 95% level
*** Significantly different from zero at 99% level

*Source: Atradius Economic Research*

of oil revenues on political and structural aspects of a country is less firm. The coefficient depicting the overall ECR score is driven into insignificance by the political and structural variables. This is our main result.

To grasp how sanctions against Russia have impacted the relationship between the oil price and ECR scores, we have also calculated the correlations before and after the sanctions. The results show the following. Firstly, all coefficients increase in size going from the pre to post sanction period. Secondly, as the economic correlation is only weakly significant in the pre sanction period, it has a stronger significance in the post sanction period. One is then inclined to conclude that this is indeed due to the sanctions being imposed. They stifle domestic and foreign investment and increase the reliance of the economy on oil. Additionally, the sanctions coincide with a drastic drop in the oil price. In a system based on expert judged it is not implausible that changes in the ECR ratings become more elastic to oil price changes as they become larger. Experts may simply act after the oil price change has surpassed a certain threshold. In such case, the increased significance is due to these two effects. Thirdly, the political and structural coefficients remain insignificant in both the pre and post sanction period.

**Table 2: Euromoney country risk score categories and components**

| Risk category | | | Full Period | | Pre-sanctions | | Post-sanctions | | Difference |
|---|---|---|---|---|---|---|---|---|---|
| | | | Correlation | p-value | Correlation | p-value | Correlation | p-value | p-value |
| Economic (30%) | 1. | Bank stability | 0.440** | 0.05 | 0.238 | 0.46 | 0.844*** | 0 | 0.06* |
| | 2. | Economic (GNP) outlook | 0.438** | 0.05 | 0.339 | 0.28 | 0.748** | 0.02 | 0.24 |
| | 3. | Employment/unemployment | 0.489** | 0.02 | 0.427 | 0.17 | 0.763** | 0.02 | 0.3 |
| | 4. | Government finances | 0.408* | 0.07 | 0.488 | 0.11 | 0.605* | 0.08 | 0.75 |
| | 5. | Monetary policy/currency stability | 0.676*** | 0 | 0.524* | 0.08 | 0.751** | 0.02 | 0.46 |
| Political (30%) | 6. | Corruption | -0.11 | 0.64 | 0.006 | 0.99 | -0.005 | 0.99 | 0.98 |
| | 7. | Government non-payment/non-repatriation | 0.325 | 0.15 | 0.18 | 0.58 | 0.299 | 0.43 | 0.81 |
| | 8. | Government stability | 0.182 | 0.43 | -0.027 | 0.93 | 0.551 | 0.12 | 0.22 |
| | 9. | Information access/transparency | -0.384* | 0.09 | -0.623** | 0.03 | -0.218 | 0.57 | 0.33 |
| | 10. | Institutional risk | -0.344 | 0.13 | -0.591** | 0.04 | 0.034 | 0.93 | 0.18 |
| | 11. | Regulatory and policy environment | 0.06 | 0.8 | 0.145 | 0.65 | 0.25 | 0.52 | 0.84 |
| Structural (10%) | 12. | Demographics | 0.049 | 0.83 | 0.038 | 0.91 | 0.295 | 0.44 | 0.61 |
| | 13. | Hard infrastructure | -0.204 | 0.38 | -0.416 | 0.17 | -0.145 | 0.71 | 0.57 |
| | 14. | Labour market/industrial relations | 0.222 | 0.33 | -0.121 | 0.71 | 0.54 | 0.13 | 0.17 |
| | 15. | Soft infrastructure | 0.321 | 0.16 | 0.245 | 0.44 | 0.509 | 0.16 | 0.55 |
| Quantitative (30%) | 16. | Access to finance/capital markets | -0.204 | 0.57 | 0.034 | 0.95 | -0.43 | 0.57 | 0.67 |
| | 17. | Debt indicators | 0.508 | 0.49 | N/A | N/A | N/A | N/A | N/A |
| | 18. | Credit ratings | 0.815* | 0.09 | N/A | N/A | N/A | N/A | N/A |

* Significantly different from zero at 90% level
** Significantly different from zero at 95% level
*** Significantly different from zero at 99% level
N/A due to lack of sufficient data

*Source: Atradius Economic Research*

We have also looked at the correlations between the oil price and the subcomponents of each of the three categories as well as the quantitative measures (credit ratings, debt indicators, access to finance/capital markets). The results are shown in Table 2. The correlations of economic variables all have a positive sign over the full sample period and are all – except for government finances – found to be significant at the 5% level or higher. No significant relation is found between the oil price and political and structural variables – except for a weak negative relation with Information Access & Transparency. Other than some empirical studies (see literature overview), we find no relationship between the oil price and corruption. We also find no trace of an impact on government stability. It means that the Russian government retains a firm hold on power. And that such power is not markedly eroded by the oil price. Besides the subcomponents of the qualitative categories, we have also looked at the three quantitative variables. As expected the credit ratings show a (very) high correlation which is significant, but only weakly. The other quantitative variables display either no significant correlation with the oil price.

Moving to the difference between pre and post sanction periods, the signs of the coefficients related to the economic variables

**Table A1: Correlation results for risk categories and components**

| Risk category | | | Measures |
|---|---|---|---|
| Economic (30%) | 1. | Bank stability | Banking sector strength |
| | 2. | Economic (GNP) outlook | Optimism economic growth outlook |
| | 3. | Employment/unemployment | Risk posed to the economy by unemployment |
| | 4. | Government finances | Country's financial strength |
| | 5. | Monetary policy/currency stability | Monetary policy effectiveness/exchange rate risk |
| Political (30%) | 6. | Corruption | How corruption affects country risk |
| | 7. | Government non-payment/non-repatriation | Risk government policies and actions pose to financial transfers |
| | 8. | Government stability | Stability of the government |
| | 9. | Information access/transparency | Accessibility and reliability of information and statistics |
| | 10. | Institutional risk | Independence and efficiency of state institutions |
| | 11. | Regulatory and policy environment | Quality of regulatory environment and how well policy is formulated/implemented |
| Structural (10%) | 12. | Demographics | Impact of demographic profile on economic growth and political stability |
| | 13. | Hard infrastructure | Adequacy of a country's physical infrastructure |
| | 14. | Labour market/industrial relations | Suitability of the labor environment for economic growth and political stability |
| | 15. | Soft infrastructure | Health of economic, medical and cultural/social institutions of a country |
| Quantitative (30%) | 16. | Access to finance/capital markets | Access to international capital markets |
| | 17. | Debt indicators | Several ratios: • debt stocks to GNP • debt service to exports • current account balance |
| | 18. | Credit ratings | Nominal values of Moody's, S&P and Fitch ratings converted into scoring card |

*Source: Euromoney*

are all positive, in line with our previous result. What really stands out is that four out of five economic variables are significant at 95% or higher in the post sanction period, whereas no or only weak significance can be found in the pre sanction period. As stressed before, this has to do with the simultaneous oil price drop and strong deterioration of the economic situation in Russia post Q1 2014. Looking at the political part of the ECR, information access & transparency and institutional risk carry negative coefficients that are significant at the 95% level in the pre sanction period. In the post sanction period, the significance of both these variables disappears. This result is arguable in line with the empirical results of Aslaksen (2010), finding a negative relationship between oil revenues and political rights. The variables belonging to the structural part of the ECR are found to be insignificant for both the pre and post sanction period.

One of our assumptions was that survey data on which the ECR scores are based were collected uniformly in each period. We therefore conducted our correlation analysis based on the country risk score as well as the average of the oil price from the same period. However, we cannot rule out the possibility that ECR survey data were mainly collected for instance in the month prior to quarter end instead of uniformly throughout the quarter. Therefore, we want to test whether the results hold if we take the average oil price from the third month of each quarter. The results from this sensitivity analysis indicate that this does not change the overall picture.[9]

Another assumption was that the oil price of the current period is the right unit of analysis for country risk. In other words, the underlying assumption is that experts who submit the ECR scores are not being influenced by oil price changes in previous quarters. To formally test whether this assumption is correct, we have also calculated correlations using a 1 quarter lagged oil price. According to the results, this leads to a disappearance of the significance of the economic coefficients, which means the 1 quarter lag in the oil price is not meaningful as an input.[10]

## 4. Conclusion

In this study we looked at the relationship between the oil price development and Russian country risk using correlation analysis. While our dataset is limited, we do find evidence that at least a strong correlation exists between economic parts of Russia's country risk score and the oil price. No such significant relationship is found for political and structural variables that are also part of the overall country risk measure. The lack of significance on these parts makes the correlation between the overall country risk score and oil price insignificant. This does not mean that the oil price decline is not important, it simply does not carry enough weight on itself to significantly influence country risk, giving that the economic part of the overall risk score carries a weight of only 30%. Therefore, the oil price is only of limited relevance for Russian country risk. It hardly matters. That is our main result. What we have also found is that the correlations increase in size if we focus on the period after the sanctions against Russia were imposed. As this period coincides with a large drop in the oil price we argue that such may have triggered experts to adjust ECR rating changes that are otherwise not made. ■

**Notes**

1 Respectively chief economist, economist and quantitative economic intern at Atradius Credit Insurance. Lorié is also affiliated to the University of Amsterdam as a researcher.

2 Source: Arezni, A. and Brückner, M. (2011). Oil rents, corruption, and state stability: Evidence from panel data regressions. European Economic Review 55 (7): 955-63. Aslaksen, S. (2010). Oil and Democracy: More than a Crosscountry Correlation? Journal of Peace Research 47 (4): 421–31.

3 For example, Hurb, M. (2005). No Representation without Taxation? Rents, Development, and Democracy. Comparative Politics 37: 297–317.

4 Country risk is a collection of risks related to doing business with a country. 'Doing business' regards investment or exporting to a country. If country risk changes in essence the ability to service investments or pay for imports is affected.

5 Based on a survey of debt syndicate managers of international banks.

6 This conversion is needed because ECR scores are real numbers as well, in the sense that ECR scores always fall in the fixed bandwidth of 0-100.

7 We have indeed run regressions using simple OLS confirming this.

8 We use the Fisher transformation because the Pearson correlation coefficients are found to be non-normally distributed (which is not surprising with such small n). The transformation solves this by converting the correlation coefficients into z-scores which we can then compare using a formula from e.g. Cohen, J., and Cohen, P. (1983). Applied multiple regression/correlation analysis for the behavioral sciences, Hillsdale, NJ: Erlbaum, p. 54. This is just a hypothesis test that there is no difference between the correlations.

9 Results are available upon request.

10 Idem.

# Political risk and trade credit policy wordings, and harmonisation in the context of the Insurance Act 2015

**By Joe Blenkinsopp, senior vice president, global head of market distribution and development, XL Catlin Political Risk & Trade Credit Insurance**



Political risk and trade credit insurance policies have become one of the key elements that can facilitate the occurrence of foreign direct investment and/or international and/or domestic trade. Without these policies such important global economic activity is often dampened down, or may in certain circumstances not happen at all, especially as not many commercial entities are willing to take these risks fully unprotected in today's highly unpredictable global political and economic environment. Given the vast variations in the way in which global economic activity can occur; not surprisingly many different methods of protection, including methods other than pure insurance, have evolved to address the myriad of opportunities facing those companies wanting to trade and invest internationally. For the sake of simplicity, it makes sense to confine the contents of this article to insurance policies governed by English law and those predominantly in the private commercial insurance sector.

## Policy wording quintessence

It may seem rather an overly obvious statement to make but at the heart of every political risk and trade credit insurance contract is the policy wording. The policy wording embodies the contractual agreement made, usually exclusively, between two willing and consenting parties who have negotiated a legally binding commercial agreement. Perhaps not surprisingly, policy wordings for this type of insurance can also take many different forms, cover many different risk situations and can be constructed in a variety of different ways to address the specific

Joe Blenkinsopp

needs of each individual insurance buyer. To have a generic harmonised one size fits all policy wording is possible as demonstrated by market standard and various published wordings. However; very often a bespoke policy wording is negotiated between the contracting parties which reflect the specific nature of the risks to be insured.

## UK commercial insurance changes

It would be possible to write a lengthy book on the many different types of policies that are available to protect foreign direct investment and global trade. However; it would be firstly remiss not to mention here the most significant change to UK commercial insurance contract law since the Marine Insurance Act 1906; being the UK Insurance Act 2015 (the Act) which introduces substantial changes to the laws governing disclosure in non-consumer insurance contracts (and to the remedies for breach), warranties and other contractual terms, insurers' remedies for fraudulent claims and contracting out. It applies to all contracts of insurance and reinsurance as well as variations to existing contracts entered into after 12th August 2016 and which are governed by the laws of England, Scotland, Wales and Northern Ireland. All of these changes were extensively consulted upon and XL Catlin had representatives at these consultations, so the vast majority of the Act's content was anticipated before it was passed into law.

**Harmonization**

Overall, we, at XL Catlin, have been broadly supportive of the changes; nonetheless, the effect of the Act on particular policies is complex and in some respects unclear. Seeking to harmonise policy wordings in the sphere of political risk and trade credit at this time, across such a wide range of options may not seem realistic in the context of such significant fundamental change to English law. However; one of the simplest and most important ways to harmonise policy wordings, especially where significantly large risk exposures need coverage, is to make full use of a multiple insurer syndication of the risk using a common policy wording. In fact, many current users of these products have come to expect insurers to be willing to participate upon a common set of policy terms, not limited just to the quantum of the premium. In some circumstances, actually the premium itself can vary between insurers on otherwise fully harmonised policy wordings as each insurer must set its own premium terms for taking the risk.

The services of a professional insurance broker with specific dedicated product teams and knowledge dedicated to this syndication process is considered to be best practice by this part of the insurance market in particular in the UK. As a customer it is very important to appreciate that unless a syndicated insurance policy is indeed on a harmonised policy wording that there could be very significant differences in the coverage and potentially important inadvertent consequences as to how any risk mitigation actions or claims and recovery work may be able to function. Differences need not necessarily be confined to simply the policy premium and particular care needs to be taken when this is the case.

**The Insurance Act**

With the arrival of the Act into law, the work of reviewing and potentially redrafting all policy wordings, which by their nature are usually bespoke, has been, or will be, significant. However, we believe that the Act reflects our philosophy of doing business in a clear, fair and client-focused way. Our approach to claims has always been to make fair decisions alongside our clients and not rely on points that might be regarded as unfair or highly technical. For instance, we announced before the Act was passed that we would not be relying upon Basis Clauses in our dealings with customers.

The parts of the Act that are of particular relevance to this article are: A) the duty of disclosure at the time of placing and remedies for breach of the duty; B) warranties and other clauses that go to loss prevention or reduction; and C) fraudulent insurance claims. As far as A) is concerned, the Act has introduced a new duty of fair presentation as well as a range of potential new remedies in the event of any breach. Policies containing clauses which touch on non-disclosure issues will need to be carefully reviewed and possibly updated in light of the Act. Where appropriate, London Market Association (LMA) clauses could be used.

**With all the technical changes brought about under the Act, it is significant to bear in mind that for political risk and trade credit policies, we are dealing very often with complex underlying activity and contractual documentation.**

Clearly, the fewer different versions of such clauses that are adopted in the market, the better it should be for customers.

Regarding B), the Act has created two new regimes, one for warranties (section 10 under the Act) and one for terms (including warranties) which would have tended to reduce loss of a particular kind or at a particular time or location (section 11 under the Act). We are concerned that the introduction of these regimes has created fertile ground for disputes and litigation owing, in particular, to the potential uncertainty as to whether or not a term is a section 11 term. In an effort to reduce the scope for litigation, which is in the interests of all concerned, we would intend to use specific statements in the policy wordings to indicate how key terms should fall to be treated under the Act, for example by stating which terms are to be considered section 11 terms under the Act. We hope and expect this will provide greater clarity as to the remedies that will apply in the event of any breach of these terms.

Regarding C), the remedies for fraudulent claims will operate by virtue of the Act and, as such, there is no need for a clause in the policy. However, if fraud clauses are to be used, then as with disclosure clauses, we recommend the use of standardized LMA clauses relating to fraud for the same reasons as already articulated above.

## Clear and present

With all the technical changes brought about under the Act, it is significant to bear in mind that for political risk and trade credit policies, we are dealing very often with complex underlying activity and contractual documentation. Despite this, best practice has often advocated the use of clear and plain English in policy wordings to describe the proposed circumstances to be insured. The range of perils to be insured can be described either on an "all risks" basis or on a named perils basis – the latter being the usual market standard for political risk and trade credit policies. In the case of trade transactions, this can be as simple as nonpayment by the debtor under the insured contract. This binary insuring clause can be simply proven – the payment has either been received or not; with any attendant reduction or proof of loss usually being relatively straightforward.

For policies covering foreign direct investment, usually the main peril covered is confiscation, expropriation or nationalization. In this sphere of activity, we have witnessed greater use of additional policy language designed to expand coverage to include many additional perils that are often found in more general property and casualty/liability insurance policies such as business interruption. Being clear at the outset of the contract on what it is supposed to cover or indeed not cover, how the quantum of loss is to be assessed and how loss and recoveries are to be handled, is one of the key ingredients for successful claims handling for all concerned in a loss scenario.

## Cooperation and innovation

For those who are by constitution and mandate set up to act as nationally owned export/import credit agencies and/or foreign direct investment insurers and/or as actors for and on behalf of their countries' national interest or multinational or even supranational entities operating in the field of political risk and trade credit insurance; it has been self-evident from years of global government cooperation agreements that working together can, and often does by necessity, produce a syndication of risk on a common policy wording. It can be very time consuming for all the various parties who are working together, on say a large power project costing many billions of dollars to construct, to reach agreement on all the terms of the insurance contract to support this important economic growth activity.

In recent years the cooperation between the private commercial insurance sector and the ECAs, multi and supranational agencies has grown significantly. Rather than seeing this as a potentially negative occurrence, we would argue that by bringing together willing and sophisticated public and private insurers, both sides can fulfill their mandates; whilst at the same time bringing certainty through policy wording harmonisation and syndication for our customers. A further benefit undoubtedly has been the ability to shorten the length of time it can take to bring some of these larger and more complex transactions to fruition through the involvement of privately owned commercial insurers.

As we all ponder the ramifications of Brexit and other fundamental shifts in global sociopolitical economics; will the global world of international investment and trade simply cease to function as a result of political decisions taken by various different politicians and electorates? This would seem highly unlikely – successful international trade and investment is at the heart of what all nations aspire to in terms of improving their populations' standard of living. In these circumstances will insurance policy wording harmonisation and a one size fits all approach for all political risk and trade credit insurance be relevant and a reasonable desirable objective? In one sense, yes absolutely, in appropriate circumstances such as syndication of risk. Given the huge variety of business opportunities available to potential users of these policies, innovation of the policy wordings within the revised new legal environment under the Act, will remain at the cornerstone of what the private commercial insurance market will do to help facilitate customers' activities in this crucial global activity. ■

# UK Insurance Act 2015: disclosure requirements and implications

**By Carol Searle, general counsel, Texel Finance Limited**

12 August 2016 has come and gone and so the long anticipated changes to English insurance law are now in force and suddenly very relevant to our industry. The Insurance Act 2015 (the act), unless contracted out of by the parties, applies to all English law insurance contracts entered into from 12 August 2016.

The radical changes introduced by the act concern the new remedies for breach of warranties and particular terms and the introduction of proportionate remedies for the breach of the duty to give a fair presentation of the risk (the duty). From a practical perspective, however, the changes that have an impact on how business is placed in a post 12 August world are those that concern the duty. The act provides a default set of rules that apply to how an insured is expected to satisfy the duty and who needs to do it. This article considers the new guidance concerning the duty and its implications for the industry.

The duty applies before an insurance contract is entered into and contains three elements. First, the duty to disclose material circumstances to a risk. The test for what is material is unchanged – anything which would influence the judgment of a prudent insurer in determining whether to take the risk and, if so, on what terms. This duty is the corner stone of insurance allowing insurance to be appropriately and effectively priced and has been retained as a key feature of a fair presentation. We come back to this. Second, as before, there is a duty not to make a material misrepresentation. Third there is a new duty concerning the form in which a presentation must be given. Information must be presented in a reasonably clear and accessible way. This is intended to target 'data dumps' where an insurer is presented with an overwhelming amount of undigested information. Information provided should be structured, indexed and signposted so that an underwriter is able to navigate to what is important.


Carol Searle

## Disclosure

The law commissions recognised that insurers should be engaged in the disclosure process and not 'underwrite at the claims stage' waiting to ask questions only when a claim was presented. The Act recognises this concept in that there are now two ways to satisfy this duty. The first and primary duty replicates the previous test – an insured must disclose all material circumstances that the insured "knows or ought to know". The second way is new. It applies if the insured has failed to satisfy the primary duty but has disclosed enough information to put the insurer on notice that it needs to ask further questions for the purpose of revealing all material circumstances about the risk; then the disclosure duty will have been satisfied. This takes into account that there may be circumstances where an insured will need guidance from an insurer to satisfy the disclosure duty and greater participation from insurers seeking clarification of information is anticipated.

The act clarifies what an insured knows or ought to know, but this clarification has given insureds many factors to consider including whether any amendments to policy wordings are required to amend and/or clarify the default position.

In broad terms an insured is taken to know what is known to its senior management or to the individuals who participate in buying insurance. In a corporate context, this is likely to include members of the board of directors but may extend beyond this, depending on the structure and management arrangements of the insured. Insureds need to identify whose knowledge within the insured's organisation will be relevant for the purpose of compliance with the duty of disclosure. Are there people whose knowledge is important to the risk who do not fall within those categories? Policy wordings may be amended by identifying those persons whose knowledge is relevant.

**Insureds need to identify whose knowledge within the insured's organisation will be relevant for the purpose of compliance with the duty of disclosure.**

In addition an insured should carry out a reasonable search both within its own organisation and of third parties. Insureds need to consider what the parameters of a reasonable search will be and how this search will be conducted both within its organisation and of third parties. The knowledge of those individuals who do not fall within the category of senior management, yet who perform management roles or otherwise possess relevant information or knowledge about the risk to be insured, may be captured by the "reasonable search" criteria. Insureds need to consider how to document and keep records of a reasonable search. Insureds should also consider how best to disclose the search parameters and processes and procedures to insurers as part of the placement process.

The act also deals with the question of insurer knowledge in the context of the exceptions to this disclosure duty. The Insured has no duty to disclose circumstances known/ought to be known/presumed to be known by the insurer. This captures those involved in making the particular underwriting decision and information held elsewhere in the insurer's organisation if it should have reasonably been communicated to the underwriter or was readily available to the underwriter. Insurers are also expected to know matters of common knowledge, that is what an insurer writing the risk would reasonably be expected to know. An insurer ought to have some insight into the industry for which it is providing insurance, but this insight may reasonably be limited to matters relevant to the type of insurance provided.

The changes to an insured's disclosure duty are evolutionary and not radical and many elements of the previous regime remain. Long-standing buyers of insurance in the credit political risk market have well established processes and procedures surrounding their purchase of insurance and policy wordings that have served them well. Many of these insureds have/are considering the act and how it reflects the way their insurance business has been conducted historically and the extent to which established practice and procedures can continue alongside the new regime. They are also considering whether their policy wordings require amendment to contract out of the default provisions of the act.

In particular bank insureds are ahead of the game as they have already grappled with their disclosure obligations for Basel compliant non payment policies to ensure that they fully understood their duties and who would discharge these. For many years now banks have had deal team/transaction team or an equivalent definition in their wordings to designate and define those persons whose knowledge is relevant for the purpose of their disclosure duties. Some corporates have also incorporated similar functioning definitions. We expect to see more definitions of this nature in policy wordings for insureds who haven't yet negotiated this.

Both existing and new buyers of the products available in the credit political risk market are in the same situation when considering their duties on placement of a risk and negotiating a wording in this new landscape. Overall, due to the bespoke nature of the products and the sophistication of the insureds purchasing credit and political risk insurance, the impact of the changes is likely to be less arduous than may be encountered in other areas of insurance. ■


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# OPIC: Political risk insurance claims and coverage for political violence – A necessary instrument for investors and NGOs to mitigate investment risk

**By Tracey Webb, Vice President, Structured Finance and Insurance, OPIC**

The Overseas Private Investment Corporation, (OPIC) is a long-time Berne Union member that mobilizes private capital to help address critical development challenges, and in doing so, advances US foreign policy objectives. As the US Government's development finance institution, OPIC provides political risk insurance and project financing for US investors, lenders, NGOs, and impact investors seeking to invest in more than 160 developing economies and countries transitioning from nonmarket to market economies.

OPIC political risk insurance – and OPIC's strong record of protecting investors and paying claims – has helped investors make a positive impact in countries and sectors where attractive opportunities merge with uncertain political and economic conditions. A fundamental benefit of OPIC's involvement as a political risk provider (including direct insurance and reinsurance) is its willingness to advocate on behalf of the insured party before conditions deteriorate to the point of causing losses and result in claims.

When OPIC is an insurer, it will work to avert claims before they materialise by working with the insured investor, other US government agencies and the local US embassy, and host government authorities. OPIC's claim process is designed to ensure protection of the insured party and the project, if possible, while prudently managing the US government funds that back OPIC's political risk insurance.


Tracey Webb

When OPIC has paid or settled claims, its recovery rate has been outstanding. Since 1971, OPIC has made 298 insurance claim payments and settlements that total $977.2 million, and its recoveries on those claims are $1.006 billion, or 103% of total claim settlements through FY2015. This information, and the memoranda of determinations that underlie OPIC's claims decisions are found on the OPIC website at www.opic.gov.

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### Types of coverage and benefits for insured parties:

***OPIC political violence coverage***

OPIC's political violence (PV) insurance coverage continues to be an important part of OPIC's risk mitigation products. This compensates investors for equity assets (including property) and income losses caused by such actions as: declared or undeclared war; hostile actions by national or international forces; revolution, insurrection, civil strife; terrorism and sabotage. In the event of such loss, OPIC pays compensation for two types of losses:

- Assets: Damage to covered tangible assets; and
- Business income: Income losses resulting from damage to assets of the foreign enterprise caused by political violence/terrorism.

Investors may purchase one or both coverages. In addition, OPIC can provide coverage for:

- Evacuation expenses
- Temporary abandonment or income losses due to political violence that causes evacuation or forced abandonment of a project
- Special riders: OPIC can also provide specialised coverage to compensate for income losses resulting from damage to specific sites outside the insured facility, such as a critical railway spur, power station, or supplier

OPIC PV coverage can be a decisive factor in enabling investors, contractors, NGOs, and educational institutions to commit capital, resources and sorely-needed expertise into countries and regions that desperately seek such support for security, stability, economic growth, and job creation.

***PV coverage and private investors***

For private investors, PV coverage can be an important factor when determining whether to invest or whether to rebuild and restart operations. For example, a US company, Seaboard Overseas Limited (Seaboard), has been insured by OPIC against political violence in several risky emerging markets.

**Zambia**: OPIC provided political risk insurance to Seabord Corp. in a project in support of food security. In 2012, OPIC paid a $38,027.37 claim to Seaboard as compensation for the adjusted cost of lost Covered Property (grain silo equipment and various food products) destroyed or taken during post-election riots in that African nation

**Haiti**: Seaboard is also part of an investor group that purchased OPIC PV coverage in Haiti that enabled the investors to mitigate the risk of doing business in one of the poorest and most unstable countries in the Western Hemisphere. The investors purchased a mill that produced as much as 95 percent of the flour consumed in Haiti that had been unfortunately destroyed during the massive 2010 earthquakes in Haiti. It was then reconstructed.

In the Haitian project, there has not been a claim but it was critical for the investors to commit their capital. OPIC PV insurance covers damage to assets or business income loss resulting from political violence. This coverage allowed the insured investors to reconstruct the facility – including a flour mill, offices, warehouse, storage silos, machine shops, and an electricity generating plant – which was completed in December 2011. Along with increased production capacity and more modern equipment, the facility created 150 local jobs and increased the supply and distribution of flour throughout Haiti.

***PV coverage and NGOs – covered property***

While OPIC frequently works with private sector businesses that use OPIC financing or political risk insurance to support their

**OPIC PV coverage can be a decisive factor in enabling investors, contractors, NGOs, and educational institutions to commit capital, resources and sorely-needed expertise into countries and regions that desperately seek such support**

operations in emerging economies, the agency also supports the work of non-profit organisations and NGOs. One long-time OPIC partner is the International Rescue Committee (IRC), one of the world's largest humanitarian organisations, which responds to humanitarian crises around the world to help address vital nutrition, health care, housing and subsistence farming needs. IRC has used OPIC political risk insurance in more than 20 countries to enable it to continue its work in countries embroiled in political violence. "The support IRC receives from OPIC is really indispensable," IRC's vice president for policy and advocacy has said. "When our operations are threatened, OPIC is right there with us providing the insurance and backup that we need to keep our operations moving forward."

Specifically, OPIC has paid separate political violence claims to IRC in three countries since 2014, totaling more than $874,000. Recently in Yemen, OPIC agreed to pay IRC up to $73,711.80 for covered property (medical supplies and office equipment) that was looted or destroyed. Similarly, in 2015, OPIC paid up to $205,000 to IRC for replacing covered property (office equipment and vehicles) lost and destroyed during armed conflict between opposing forces in South Sudan, where IRC has been working to stem gender-based violence and provide health care and child survival programs. And in 2014, OPIC paid IRC a $595,413.40 claim to replace destroyed covered property (office equipment and vehicles) in the Central African Republic, where IRC has been providing emergency aid and long-term assistance to refugees and displaced persons since 2006.

***PV coverage and educational institutions – evacuation coverage and loss of income***

In 2011, OPIC provided political risk insurance in connection with the American International School of Bamako in Mali. The insurance protected against loss of business income, including evacuation expenses that resulted from political violence. At that time, the West African nation was a stable democracy. But in the year after OPIC provided the insurance, the political situation in Mali deteriorated rapidly, a group of Malian soldiers seized power, which caused school officials to evacuate and close the school. After reopening the school in August, a claim was filed for loss of income resulting from the political violence, and in February 2013, OPIC paid a claim of almost $1.4 million. Today the school is open as it continues to monitor security in the region. Its ongoing operation is helping support the community of international aid workers and diplomats who are helping advance development and stability in Mali.

**Potential opportunities for cooperation**

Recently, OPIC has focused its efforts on working more closely and effectively with other investment insurance providers. This has resulted in new and innovative facilities where OPIC has entered into reinsurance, pooling, and other risk sharing agreements with private insurers and with public insurers, both multilateral and bilateral.

It is reasonable to hope that these efforts will result in political risk insurance facilities that can mitigate the daunting risks of political violence faced by investors and developers seeking to develop critically needed projects, e.g., humanitarian assistance, transportation infrastructure, water, and waste treatment and agricultural. OPIC's history and familiarity with PV coverage and claims provide a sound foundation to find ways to cooperate among Berne Union members to meet the needs of the insured, while being fully compliant with the relevant criteria and objectives of the insurers. ■

**OPIC's history and familiarity with PV coverage and claims provide a sound foundation to find ways to cooperate among Berne Union members to meet the needs of the insured, while being fully compliant with the relevant criteria and objectives of the insurers.**

# Political risk and political violence in South-East Asia

**By Mark Wong, managing director, credit, political and security risks – Asia, JLT Specialty**

Political volatility and political violence have increasingly provided cause for concern in South-East Asia over the course of 2016. Concerns include an uptick in domestic protests in response to the prolonged scandal involving the Malaysian sovereign investment fund, 1Malaysia Development Berhad (1MDB). The continued junta rule in Thailand will also likely contribute to renewed political tensions. In addition, the newly elected Philippines President Rodrigo Duterte's war on drugs and other controversial decisions are also likely to contribute to nationwide unrest. The territorial disputes in the South China Sea are persisting as China rejects a judgement awarded by an international tribunal and political violence and terrorism continues to threaten South-East Asia as the rise of the Islamic State leads to terror attacks in Indonesia and Malaysia.

Political volatility and the frequency of terrorism events could be a hurdle to investment and growth in the region, especially when the Asian Development Bank forecasts GDP growth for 2017 at 4.8%. Though investors and lenders are keen to participate in the region's growth story, they will need to fully understand the political and credit risks in the region in order to mitigate and manage their exposure to them and to maximise their opportunities.


Mark Wong

## Malaysia

Controversy first surrounded 1MDB in 2015 when the Malaysian sovereign fund started to miss coupon payments to bondholders. Following which, a scandal unfolded, spurring involvement from various foreign governments in the alleged misappropriation of billions of dollars from the fund. Government officials who criticised the scandal were removed from their positions, a crackdown on the media's coverage on 1MDB ensued and Prime Minister Najib was given sweeping security powers amid protests. With the clamping down on civil liberties in Malaysia and mounting discontent, rallies and protests are likely to continue, facilitated by opposition parties. This has resulted in increased concern from investors and reduced lending. In addition, low oil prices and a weak ringgit have put a

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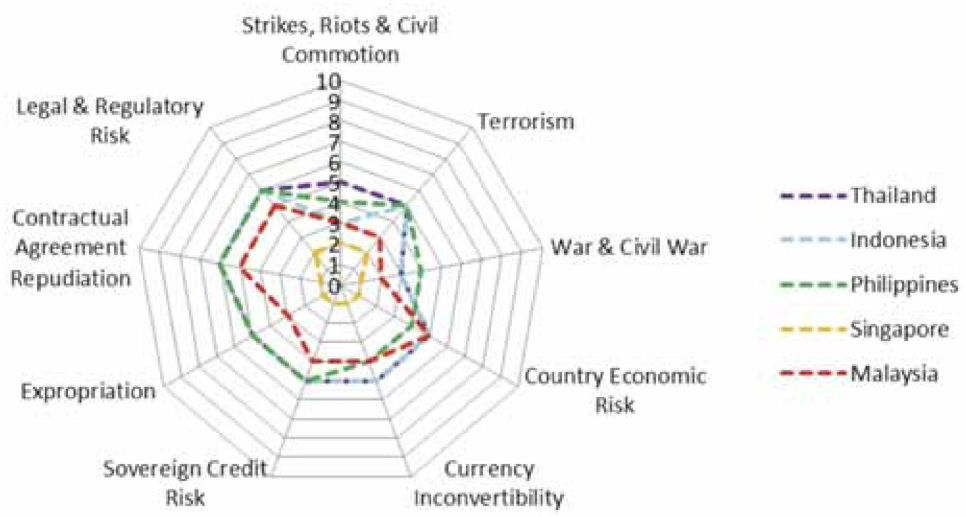
drag on the Malaysian economy. 30% of the state's revenues come from oil-related taxes and economic stagnancy is likely given the lack of alternative income. Heightened concerns in these areas have promoted activity in the private credit and political risk insurance (CPRI) market with investors and lenders seen actively managing and covering their investment exposures with the market. The CPRI market has previously been underweight on Malaysia and premium rates are still well within deal margins.

**Thailand**

Since the military seized control of the country during a coup in 2014, Thailand has been ruled under a strict military regime. Order might have been restored following a prolonged period of political unrest that led to Yingluck Shinawatra's government being ousted but this came at the expense of civil liberties. Coup leaders have also granted the army sweeping powers to arrest and detain criminal suspects, entrenching military control over the country. Results of a vote on the junta's proposed draft constitution in August 2016 suggest an election next year. It is likely that Thailand will transition towards democracy, however, it should be noted that the constitution only offers semi-democracy whereby future elected governments will be supervised by the military. There is a significant risk of large-scale protests in Red Shirt strongholds in the north and northeast

**World Risk Review Ratings: September 2016**




Source: World Risk Review, JLT's Proprietary Country Risk Rating Tool
http://jlt-talos.com/services/worldriskreview/

| | *Thailand* | *Indonesia* | *Philippines* | *Singapore* | *Malaysia* |
|---|---|---|---|---|---|
| Strikes, Riots & Civil Commotion | 5 | 3 | 4 | 2 | 3 |
| Terrorism | 5 | 5 | 5 | 2 | 3 |
| War and Civil War | 3 | 3 | 4 | 1 | 2 |
| Country Economic Risk | 5 | 5 | 4 | 1 | 5 |
| Currency Inconvertibility & Transfer Risk | 5 | 5 | 4 | 1 | 4 |
| Sovereign Credit Risk | 5 | 5 | 5 | 1 | 4 |
| Expropriation | 5 | 5 | 5 | 1 | 3 |
| Contractual Agreement Repudiation | 6 | 6 | 6 | 1 | 5 |
| Legal & Regulatory Risk | 6 | 6 | 6 | 2 | 5 |

Countries are rated between 1 and 10. 1=Low Risk, 10=High Risk.

of Thailand as well as in Bangkok as the government implements measures to ban or weaken opposition parties, in particular those supporting Thaksin Shinawatra, the former prime minister.

Historically, Thailand has experienced several transitions between military rule and democracy. Since the coup in 2006, in which Thaksin was overthrown, continued political volatility has become a norm in Thailand and with another transition back to military rule in 2014, there has been prolonged impact on the economy. As such, investors and lenders are likely to take a wait-and-see approach for 2017. The CPRI market continues to offer coverage for Thailand and insurers have taken into consideration the country's recurring government transitions and political risk insurance premium for Thailand has been creeping up over the past few years.

**Philippines**

Following his successful election in May 2016, President Duterte pledged to crack down on drug dealers and criminal gangs, resulting in 1,800 individuals having been killed by the end of August 2016. President Duterte's war against drugs and crime, and the trade off in allocating public monies could result in dissatisfaction amongst the Filipinos and potential unrest as budgets of the police, military and presidential office were raised at the expense of spending on health, agriculture, labour, employment and foreign affairs. President Duterte has also criticised the mining industry, declaring that the Philippines could do without this industry and warning mining companies to adhere strictly to environmental rules or risk being shut down. Though there is much potential in the Philippine mining sector, investors could face increased licence cancellation risks even though the president eventually adapted his stand and confirmed that mining permits will still be issued.

**South China Sea**

China's historic claim to sovereignty under the 'nine-dash line' area of the South China Sea (SCS) was rejected on 12 July 2016 by the Permanent Court of Arbitration (PCA), alongside its proclaimed entitlement to the full exclusive economic zone (EEZ). The arbitration, initiated by the Philippines,

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commenced in January 2013. It is likely that the Philippines and China will seek a negotiated solution to their contested territorial claims, in spite of the ruling.

The Philippines and China are calling for restraint in the aftermath of the PCA ruling in order to avoid military escalation. It is likely that China will seek to further embed itself in the area by enhancing its land reclamation efforts on disputed areas as well as further exploiting traditional fishing grounds by encouraging expanded fishing by its fishermen militias. It is also possible that China will declare an Air Defence Identification Zone. The Chinese air force sent H-6K bombers alongside other aircraft on 15 July 2016 and advised that regular patrols of the SCS will continue indefinitely.

The Philippines is buoyed by the outcome of the ruling. Nonetheless, President Rodrigo Duterte has indicated that this ruling will serve as an opportunity for defining bilateral relations rather than legitimising any form of drastic action. Although the ruling provides legal support for the Philippines to operate in

**Low oil prices and a weak ringgit have put a drag on the Malaysian economy. 30% of the state's revenues come from oil-related taxes and economic stagnancy is likely given the lack of alternative income.**

the SCS unimpeded by China, the international court does not possess the power to enforce this ruling. Duterte will have to respond to nationalist demands for control to be reasserted, particularly of the Scarborough Shoal, however this could lead to heightened hostility with China.

The SCS facilitates approximately $5 trillion of trade annually and significant fishery, oil and gas resources are also present there. The ruling will likely result in the Philippines regaining access to the oil and gas and fisheries of the SCS, which was denied by the Chinese naval blockades of 2012. However, timelines for these discussions with China are unconfirmed. President Duterte was elected amidst a commitment to promote the growth of the economy and requires Chinese investment in order to achieve this. As such, President Duterte will likely show restraint from enforcing the ruling by sending coast guard or naval vessels to patrol the Spratly Islands.

The favourable result of the tribunal for the Philippines may precipitate further claims from Brunei, Malaysia and Vietnam in particular. Existing trade ties with China have so far dissuaded these sovereigns from pursuing claims in the SCS.

## Political violence/terrorism

The terrorism threat in Southeast Asia is evolving and there has been an uptick in attacks carried out by the Islamic State, with successful attacks in Indonesia and Malaysia most recently. Security measures throughout the region have been strengthened and authorities have detained suspected militants with ties to terrorist organizations, thereby avoiding serious incidents. With porous borders within Southeast Asia, security agencies of the various countries are working together to prevent further terror attacks. In August 2016 the Indonesian police arrested six militants with links to Islamic State, reportedly planning a rocket attack on Singapore. Throughout 2016, there have been lone wolf attacks in Jakarta, a grenade attack at a nightclub near Kuala Lumpur, the attempted suicide bombing in an Indonesian Catholic church and the recent bombings across various provinces in Thailand, including tourist spots like Hua Hin and Phuket. It is likely that there will be further IED attacks targeting tourist destinations in Thailand, such as Bangkok, Koh Samui and Phuket, as well as government offices and police stations outside the three southernmost provinces. The peace process between the government and Muslim-Malay rebels has been granted increased priority. However, it is likely that there will be further attacks against foreigners in the coming months as the Muslim-Malay rebel groups have exchanged statements of support with the Islamic State, indicating that it is evolving from prioritising an ethno-religious aim to having a wider Islamist objective.

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Islamic State has an increasingly global reach and the risk across Southeast Asia has been raised. Law enforcement agencies throughout the region have stepped up efforts to counter this threat and we have seen increased interest from clients as they explore political violence and terrorism insurance solutions covering loss of revenue with the private political violence insurance market. ■

**President Duterte has also criticised the mining industry, declaring that the Philippines could do without this industry and warning mining companies to adhere strictly to environmental rules or risk being shut down.**

# Central Asia: Transition-in-process

**By Norm Kimber, Zurich Credit and Political Risk**

Twenty-five years ago the five nations of Central Asia (CA) – Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan – emerged from the shadows of Soviet central control to embark on a transitional process expected to result in the development of market-based economies. That transition is still a work in progress, which this article describes, highlighting facts and observations that may be of interest to those considering business opportunities in these emerging markets.

## The Berne Union in Central Asia

The Berne Union footprint in CA has grown steadily since 2005, with year-end exposures increasing by about 500% over the period 2005-2015, reaching just over $29 billion in 2015. In comparison, regional GDP (nominal) grew by 250% over the same period[1]. So Berne Union activity in the region has grown twice a fast as the region has grown over the last decade. While Kazakhstan accounted for about 62% of total year-end exposure in 2015, BU members have significant exposure in all five CA countries.

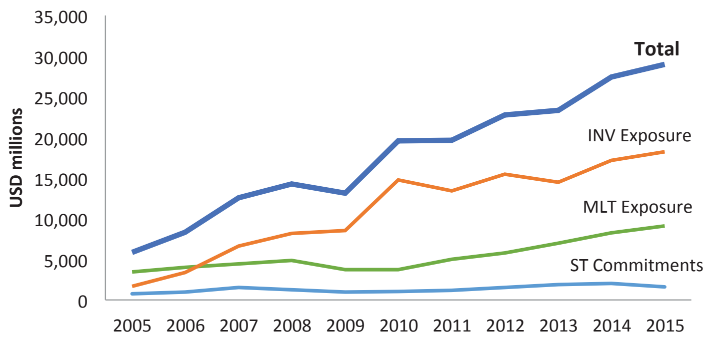
## Observing Central Asian economic transition: Hindsight is 20/20

It is much easier today, with the benefit of 25 years of experience, along with knowledge of recent external economic shocks (the "new" oil crisis, recession in Russia and the slowdown in China), to understand the challenges of transition for CA countries and identify key success factors for the next 25 years of transition. Under USSR leadership, economies of the Soviet republics were specialised and interconnected within a broader, albeit isolated, economic community that while considered inefficient in some Western eyes, was highly integrated and did not require independent sovereign decision making. Following a few years of initial volatility, low hanging fruit such as previously underutilised natural resources and human

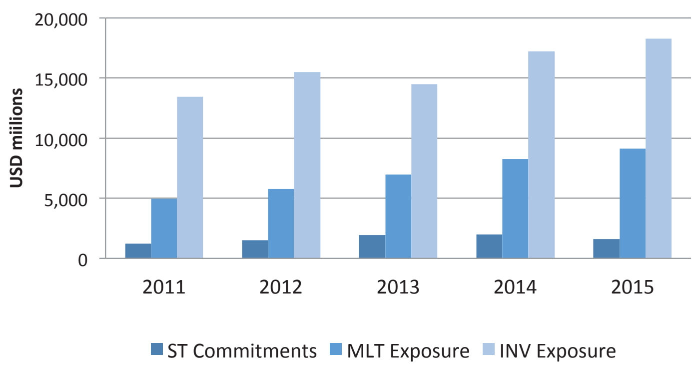
Norm Kimber

capital, as well as a prolonged period of increasing commodity demand and prices, fueled relatively rapid GDP growth in CA, averaging 7.5%[2] over the first 20 years or so of full-on independence. Readily achievable growth in this initial period of transition made it easier to avoid proactively tackling longer-run challenges related to fundamental, structural economic transition through diversification.

**BU Total Exposures (year-end)**




**BU Total Exposures (year-end)**



***Dependence on commodities***

CA oil and gas exporters, Kazakhstan, Turkmenistan and Uzbekistan, have been heavily dependent on strong hydrocarbon prices to support their economies. In Kazakhstan, oil and gas directly accounts for 20% of GDP, 50% of fiscal revenues and 60% of exports. In past years the country has run capital account surpluses largely due to favourable oil and gas prices. But breaking even from a capital account and fiscal balance perspective, in 2017 for example, would require an oil price of about $85 per barrel[3]. Turkmenistan and Uzbekistan are less diversified than Kazakhstan so they are more dependent on oil prices. Assuming prices remain lower than in past years, all three of these countries will need to diversify economic activity to continue transitional growth.

***Dependence on Russia***

CA oil and gas importers, Kyrgyzstan and Tajikistan, depend indirectly on hydrocarbon prices through remittances from domestic human capital employed in Russia and neighbouring countries that are directly affected by the decline in oil prices and, in the case of Russia, commodity price and sanctions driven recession. Remittances account for 45% of GDP in Tajikistan and 30% in Kyrgyzstan[7]. External shocks affecting Russia and neighbouring CA countries are immediately transmitted to Kyrgyzstan and Tajikistan through declining remittances, which has an offsetting effect on the benefit of cheaper energy supply. Kazakhstan, Turkmenistan and Uzbekistan also rely on remittances, as well as hydrocarbon export earnings from Russia. So when Russia sneezes, CA very quickly catches a cold, and since Russia's economy is hydrocarbon dependent and affected by sanctions, so are the economies of CA oil and gas importers and exporters.

Renewed CA transition efforts will require diversification away from dependence on Russia as well as oil and gas. Like many countries that have enjoyed years of robust economic growth based upon reliance on high commodity prices, especially in oil and gas markets, without looking ahead to potentially leaner times and the need for

## Kazakhstan: Shifting focus in response to the oil price shocks

Kazakhstan's growth in GDP terms has been impressive averaging 8.1% over the period 2000-2012, but dropping to just over 1% in 2015, a trend that reflects the country's dependence on oil and gas production[4]. One response to external economic shock resulting from declining oil prices appears to be tightening state control of the other subsoil resources and, in particular, uranium, an industry in which it has a strong market position, accounting for about 40% of world production in 2015[5]. Introduction of a long awaited, new mining code was expected in 2016, but has been postponed to 2017. Details are not yet readily available, but observers expect the new code will favour increased state control of sub-soil resources. It remains to be seen what impact this will have on existing and new foreign investment and, in turn, future prospects for foreign investors.

In March of this year, the government announced that, in its view, some foreign investors in the uranium sector have not lived up to their mine development commitments under joint venture agreements with Kazatomprom, and that it may need to respond by returning some assets to the state. This pronouncement was likely intended to prompt foreign investors in the uranium sector to respond with proposals that will lead to increased production value and redistribution of joint venture ownership benefits to the state. Cameco Corporation, one such investor, subsequently signed a publicly announced agreement with Kazatomprom[6], which is expected to increase Kazakh ownership in JV Inkai from 40% to 60%, extend the duration and quantity of existing mining rights, and lead to enhanced uranium processing opportunities within Kazakhstan. This is a good example of partnership, with a foreign investor demonstrating flexibility in view of economic transition challenges faced by host government investment partners, as well as transparency by both parties in communicating intentions to the public in an open and detailed manner.

These developments probably reflect government concern over the future value of oil and gas reserves, and realisation that economic transition by the country since independence has not sufficiently emphasised diversification.

developing a broader economic base, CA countries now face the challenge of simultaneously dealing with the immediate effects of external economic shocks, diversifying to reduce disproportionate dependence on commodities and other countries, as well as continued transition with the benefit of hindsight.

## Moving forward – what will the future look like?

Kazakhstan is in a relatively stronger position in adjusting to the new oil crisis than some of its CA neighbours, having built up foreign exchange reserves (currently more than 7 months of imports) and avoided heavy indebtedness (debt/GDP currently sits at about 22% compared to closer to 70% in Kyrgyzstan)[8]. It also has the advantage of having established sovereign wealth fund Samruk-Kazyna, which provides the country with some added financial flexibility. But like hydrocarbon dependent countries in the Middle East, it will need to diversify relatively quickly to avoid sliding backwards in future years of transition. Other hydrocarbon exporters, Turkmenistan and Uzbekistan, also enjoy temporary buffers, but are less diversified than Kazakhstan and are feeling the new oil crisis crunch sooner and more acutely. Other CA countries, Kyrgyzstan and Tajikistan, that are indirectly, but more quickly, affected by the new oil crisis, transmitted through disproportionate dependence on Russia and its economic woes, will feel the need to diversify more immediately and, arguably having weaker institutional and structural foundations to build upon, may need to rely more on donor assistance and lending. Unemployment related to returning expat workers may also result in increased, additional social burdens.

Going forward, foreign exporters, lenders and investors will hopefully find themselves pursuing infrastructure, value added natural resource production and manufacturing sector development opportunities in the CA region, as diversification proceeds.

### *Central Asia and China*

Economic linkages between CA and China have been steadily growing[9], which is not surprising given China's need for natural resources and the region's need for growth in trade and investment. Trade between China and the region, including Caucasus neighbours Armenia, Azerbaijan and Georgia, grew from only $5 billion in 2005 to close to $50 billion in 2014, with China accounting for significant shares of total trade for Kyrgyzstan (50%), Tajikistan (42%), Turkmenistan (27%), Kazakhstan (22%) and Uzbekistan (21%). Over the same period, Chinese official lending to the region grew from $260 million to almost $4.5 billion. FDI from China reached $5.5 billion in 2012 and is expected to increase to $30-35 billion by 2020. So diversification away from Russia is fortunately already underway, although economic slowdown in China is another source of economic stress that the CA region would have preferred to avoid.

### *Geopolitical affiliations – location is everything*

**The New Silk Road?**

To support resource access, it is said that the China sponsored One Belt One Road initiative is to construct a Silk Road Economic Belt that will stretch through Central Asia connecting China to Europe and providing opportunities for development through infrastructure gap filling and economic diversification[10]. All five CA countries are members of the $100 billion Asian Infrastructure Investment Bank, which will support this initiative alongside a separately allocated $40 billion Silk Road Development Fund. Details of the new Silk Road concept remain somewhat vague, but the concept does seem to mesh well with growth in China–Central Asia economic trade and investment to date. Chinese strategic intentions vis à vis investment in Central Asia may resemble resource access motivated investment approaches in Africa, except closer to home and on the way to EU markets.

**European Economic Union (EEU): Soviet 2.0 or pivot to Asia?**

Although originally proposed by Kazakhstan as an idea in the 1990s, more recent institutional development and the 2014 treaty of the Eurasian Economic Union (EEU) are thought to be the brainchild of leadership in Moscow. The EEU is an economic union of states that is said to be Eurasia's answer to the EU common market. A treaty establishing the EEU was signed on 29 May 2014, with currently membership limited to Russia, Kazakhstan, Kyrgyzstan, Belarus and Armenia, prompting some Western observers to conclude that the objective is to resurrect a new version of Soviet-style regional integration. That could be the case, as other CA and former-Soviet republics consider membership. Another view is that it could also be part of Russia's so called pivot to Asia, which was underscored by the $400 billion thirty-year gas delivery agreement signed between Gazprom and CNPC in 2014. There has been some speculation that the EEU will attract interest in formal cooperation, if not membership, by China, which would certainly boost the organisation's economic diversity and significance. There is some precedent for this in a similar alliance, the Shanghai Cooperation Organisation (SCO). All five CA states, along with Russia and China, are members of the SCO.

Turkey has thus far not been involved with the EEU, perhaps preferring the prospect of EU membership, but with EU accession appearing further in the future, and with tensions rising between Turkey and some Western powers, and recent reconciliation in diplomatic relations between Russia and Turkey, it is possible that Turkey could consider a formal relationship with the EEU. Turkey and four of the CA states share Turkic heritage and cooperation on some levels has been evident since CA independence, as illustrated by mutual membership in the Cooperation Council of Turkic Speaking States (www.turkon.org). At the very least, Turkey likely views the region as being geopolitically important and can be expected to welcome opportunities to foster soft power through economic cooperation in the region.

In short, Central Asia is geographically located to be integral to the interests of a number of potential economic partners and geopolitical affiliations, which may provide a partial means to increased diversification and continued economic transition. Foreign investors ought to follow these developments closely in assessing what the future will look like in the region and what opportunities that future will bring.

## Key take-aways for foreign business interests

1. Although it has been 25 years since CA states gained independence from the former-USSR, economic transition remains a 'work-in-progress'.

2. Regional and individual GDP growth rates have been significant over the last 20 years, largely because of direct and indirect gains from unsustainably high hydrocarbon and other commodity prices.

3. Dealing with economic shocks resulting from the new oil crisis, recession in Russia, and slowdown in China, are hard felt in all CA states and will preoccupy decision makers over the coming several years.

4. In particular, the coming years of transition should be characterized by economic diversification away from commodity reliance and dependence on Russia, leading to business opportunities for foreign exporters, investors and lenders in the infrastructure, value added natural resource production and manufacturing sectors.

**Economic linkages between CA and China have been steadily growing[11], which is not surprising given China's need for natural resources and the region's need for growth in trade and investment.**

5. The geographic location of the CA region means that it will be increasingly important to neighbouring economic powers including China, Russia, Turkey and the EU. Geopolitical affiliations will be important to the region's continued economic transition provided such partnerships are managed with a long-term strategic focus and in a mutually beneficially manner. Foreign investors will need to be prepared to take a similar approach to establishing and managing partnerships with host governments. ■

**Notes**

1 "Regional Economic Outlook Update: Middle East and Central Asia", International Monetary Fund, April 2016.
2 The Caucasus and Central-Asia: Transitioning to Emerging Markets, International Monetary Fund, 2014.
3 "Regional Economic Outlook Update: Middle East and Central Asia", International Monetary Fund, April 2016.
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5 World Nuclear Association, May 2016.
6 "Cameco and Kazatomprom Sign Agreement to Restructure JV Inkai", Press Release May 27, 2016, available at www.cameco.com.º
7 "The Spillover Effects of Russia's Economic Slowdown on Neighboring Countries", International Monetary Fund, 2015.
8 Data reported by Standard & Poors Ratings Services, from various sources, March 2016.
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EXPERT ANALYSIS

# Latin America: The (incomplete) turn to the right

**By Keith Martin, senior consultant to Aon Brazil and Veracity Worldwide[1]**

The past year has seen a remarkable reversal of fortunes for the leftist regimes throughout South America. With the exception of Rafael Correa in Ecuador, all the others have experienced defeats. In Argentina and Brazil, Cristina Kirchner and Dilma Rousseff have been replaced by decidedly pro-market presidents. And in Bolivia and Venezuela, the presidents hang on, but have suffered stinging defeats – in the case of Venezuela, the Parliament is now solidly controlled by the opposition to Pres. Maduro, with efforts under way to recall him, and in Bolivia, Pres. Evo Morales was defeated in his attempt to change the Constitution in order to run for a fourth term. Finally, the peace agreement in Colombia, ending 50 years of civil conflict, is a tacit acknowledgement by the FARC rebels that they were under siege.

What does this mean for the region, in particular in terms of trade and investment, and the need for risk mitigation? It is worth examining the individual cases of the region's three largest economies – Brazil, Mexico and Argentina – as well as the two main trading blocks of the region (the Pacific Alliance and Mercosul).

## Pacific Alliance vs. Mercosul

Over the past five years, according to the WEF, the pro-market bloc of Latin America


Keith Martin

(Mexico, Chile, Peru and Colombia) has enjoyed greater GDP, export and import growth than Mercosul. Additionally, especially since Venezuela joined Mercosul, that group had become little more than a (left-leaning) political talk-shop. Currency problems in Argentina and Venezuela meant that, even within the bloc, restrictions were imposed and intra-bloc trade slid.

With the election of President Macri in Argentina and the confirmation of Pres. Temer in office, most leaders in the region are already clearly in favor of revitalizing the economic aspects of Mercosul, including in negotiations with the EU, US and others. However, protectionist sentiment continues to run high, even in some wings of the respective ruling coalitions. And, in the context of a nearly worldwide backlash against globalisation in general, and trade agreements specifically, it is difficult to imagine that the new impetus that Macri and Temer bring to Mercosul will quickly result in new agreements with Europe or the US. Talks with the EU may have restarted, but given the

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scrutiny in Europe of potential agreements with Canada and the US, it is unlikely that the new talks with Mercosul will have rapid results. On the other hand, the region may still see progress in three areas: within the Pacific Alliance and within Mercosul, respectively, and between the two blocs, now that the main players in Mercosul have moved ideologically closer to the Pacific Alliance. In particular, if the US were to turn more protectionist after the elections there, deeper Latin American integration may be one of the answers that would united countries from Mexico to Argentina.

It is worth noting, however, that there are both structural and political impediments to such a process. On the structural side, the predominance of commodity exports means that most countries are more inclined to be competitors than to be able to harness complementary competitive advantages. Similarly, both the volatility in commodities and the economic mismanagement in several (mostly Mercosul) countries has resulted in great currency volatility – making trade and investment flows more difficult, and concerning foreign investors and traders. On the political side, despite the now more pro-market rhetoric, it is clear that politicians in the countries of both alliances are seeking to harness deeper regional integration for short-term political gain, too – and hence will be resistant to relax their own protectionist measures.

## Brazil

Expectations are that Brazil will next year finally emerge from its worst recession in a century. Early signs are that the confirmation of Temer as president will help accelerate and increase that upward potential – but much depends on the new government's ability to get much-needed reforms passed in the next two years. Early indications are that Temer – who was previously president of the lower house of Congress – will be able to push through significant labor and pension reforms, as well as launch a wave of privatisations and concessions. (The labour reforms, in particular, are likely to result in street protests and potentially even violence – particularly if they coincide with the potential arrest of former president and left-wing hero, Luiz Ignácio "Lula" da Silva. One can expect, however, that the violence will be limited in scope and concentrated on a few large cities.)

These reforms are important, if minimal, steps toward putting Brazil back on track. Deeper reforms – of the dysfunctional political system itself and of the byzantine tax code, for example – will most likely wait until after the 2018 presidential election (and perhaps much longer...). So, the most likely scenario is that Brazil will return to its "general form": institutionally solid but fragmented; growing, but below its potential; and resolving problems only, as Brazilians say "at the 48th minute of the second half".

For foreign investors, the scenario is favourable – at least until the very unpredictable 2018 elections. Brazil's current fiscal crisis means that the government is openly counting on foreign investment for the much-needed modernisation of the country's creaking road, rail, port and airport infrastructure – and is willing to provide more favorable terms to those investors than the previous one. Investors may also look forward to a "bargain basement" moment for Brazilian corporates, on two fronts. First, while it cannot politically put through privatizing large state-owned companies like Petrobras and Eletrobras, the government has made it clear that significant parts of their empires will be privatized (and that means: probably sold to foreign investors). At the same time, local content and co-investment rules (for Petrobas, but also for airport concessions) are being relaxed. Second, private corporates are also attractive targets now, given the depreciation of the real and the precarious

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situation many find themselves in after three years of recession. (The telecoms giant Oi is only the most spectacular example of this.)

However, significant challenges remain – not least of which is the fact that the corruption scandals just keep widening and engulfing more companies and politicians. The federal prosecutors and police have demonstrated a striking independence from all the parties in Brasília, determined to look under more and more rocks. Given the endemic nature of the propinoduto (funneling of bribes), they are finding evidence under every rock. The Temer government will have a major challenge to try to maintain stability – and get its reforms passed by Congress – while the investigations continue to cause indictments among leading politicians of all stripes, most likely including more members of the government, too. This is also a challenge for foreign investors: careful analysis is necessary to ensure that the assets that may be on sale in the "bargain basement" are not toxic in some non-financial manner.

In sum, we expect that the region's powerhouse will regain some of its luster but significant challenges remain – not least after the 2018 elections. This should result in an increased demand for PRI, as investors see opportunities but also risks. (It is worth remembering that in the early 2000s, Brazil was the country with the single largest PRI exposure in the world – and very scarce capacity from private insurers for it.) Trade credit is also likely to increase, particularly on the medium- and long-term side, as foreign companies come in to export more goods and services under the privatizations and concessions.

### Mexico

*"Pobre México – tan lejos de Dios, tan cerca de Donald Trump!"*

This new adaptation of an old Mexican saying sums up well one of the major clouds hanging over Mexico's future. Much more closely linked to the US than the other Latin American countries, the US elections will have a direct impact on Mexico, whoever is elected. And of course, in the case of a Trump administration, those impacts are expected to be much more drastic.

On the domestic front, Mexico under President Peña Nieto has demonstrated a willingness to try to reform and open up, even at a political cost. In the first two years after assuming the Presidency in late 2012, he proved to be a powerful reformer, especially by Mexico's sclerotic standards. With the help of opposition parties in the Congress, he managed radical changes that often required constitutional changes: reforming the energy sector, including opening up drilling to foreign companies beyond Pemex; lowering taxes; taking on the teachers' unions to improve education; and promoting pro-market policies in trade and tax.

However, that honeymoon has not lasted. Peña Nieto, who cannot be reelected at the next presidential election in July 2018, now has an approval rating of only 23% – and definitely not helped by his much-maligned decision to invite Donald Trump for a visit. Personal scandals involving him and his wife have undermined his credibility – especially as he was seeking to get Congressional approval of sweeping anti-corruption laws (finally passed in July 2016). The sluggish economy – hurt by low oil prices and the tepid pace of the US recovery – has been another weak spot. But perhaps the greatest concern of many Mexicans remains the security situation: not only the wars against and among the drug traffickers, but also the apparent emergence of hit squads targeting other groups, such as teachers' unions.

From the investment and trade perspective, it remains clear that Mexico is an attractive partner – including because of the NAFTA access to the US and Canadian markets. If the next US president were to decide to scrap or revamp that treaty (which is obviously only likely under a Trump presidency), this could spell serious trouble for investors, exporters and importers. Another threat may lie in the very "success"

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of the reforms: the 2018 elections may be a referendum on Peña Nieto's economic policies, which created more efficiency – and more unemployment and inequality. A backlash, particularly from the left is possible: Andres Manuel Lopez Obrador, who nearly won the 2006 elections and was again runner-up in 2012, may try again, and has espoused his opposition to Peña Nieto's policies. As in Brazil, things look positive for foreign investors and exporters – but only for the next two years, until presidential elections again cloud the crystal ball.

**Few countries in Latin America have experienced as radical a policy shift in a short time as has Argentina in the transition from President Cristina Kirchner to President Macri. From exchange rates to publishing verifiable inflation statistics, Macri has wasted no time in moving toward an agenda aimed at reassuring foreign and domestic investors.**

### Argentina

Few countries in Latin America have experienced as radical a policy shift in a short time as has Argentina in the transition from President Cristina Kirchner to President Macri. From exchange rates to publishing verifiable inflation statistics, Macri has wasted no time in moving toward an agenda aimed at reassuring foreign and domestic investors. The fact that Argentina's $16.5 billion return to the international bond markets in 2016 was oversubscribed and resulted in surprisingly tight pricing for a country that has defaulted twice in the past twenty years is evidence that investors want to believe that "this time will be different."

Yet, the situation is complex. Removing energy subsidies has caused both a massive (if mostly one-off) spike in inflation. As many people have found the price hikes unaffordable, it has also resulted in widespread demonstrations against the government. Many other necessary reforms – particularly to take on the bloated and inefficient public sector – are being postponed, not least because Macri must rely on support from the opposition-controlled Congress to push through his reforms. (He may hope that next year's Congressional elections will strengthen his hand, but that is far from certain.) The recovery is now only expected to begin in 2017 and Macri is pleading for patience – in a country with a historically rather limited reservoir of that commodity. The Supreme Court, for example, has already ordered a partial rollback of the energy price increases.

Beyond the bond issue, which bought Macri some breathing room, Macri – like his Brazilian counterpart – is betting on foreign investors to fund many of the needed investments in infrastructure. And despite Argentina having been the "world champion" of investment insurance claims and international arbitral decisions against it, many are indeed looking at the opportunities with interest. Notwithstanding the currently drop in oil prices, there is global interest in Vaca Muerta, one of the world's largest untapped shale gas and oil reservoirs, located in the remote Patagonia region. Exploiting it would require billions of dollars in investment, not only in the fields, but also in the ancillary infrastructure (pipelines, ports, etc.).

Finally, Macri is clearly keen on rekindling the country's glorious exporting past, particularly in agricultural commodities. Gone are the punishing taxes and hard currency retentions that the Kirchners placed on those exports. While exports are rebounding, it is unclear how much they will help plug the hard currency hole Argentina faces. (While the bond issue provided on short-term fix, he is counting on investments and exports, as well as an amnesty programme designed to encourage Argentinians to "on-shore" their offshore assets, as longer-term solutions to the reserve crisis.)

As anyone who has been working with Argentina over the past twenty years knows, radical shifts are a common occurrence – and often foreign investors are left holding the bag. Additionally, matters are complicated by the fact that much political (but little tax) authority resides with the provinces. This means that foreigners looking at concessions will often face a double risk: federal and provincial. The question will be: will foreign insurance providers be as bold as some foreign investors and bondholders, and return to covering Argentina risk? ■

**Note**

1 The views expressed in this article are strictly the personal ones of the author.

# Key political risks in the Middle East and North Africa

By IHS Economics and Country Risk

## Egypt

President Abdel-Fattah al-Sisi faces a range of challenges including reducing Egypt's dependency on Gulf aid, cutting government spending through subsidy reform, restoring investor confidence despite a growing insurgency, quelling recurrent strikes, and avoiding mass economically-motivated unrest. The severe difficulty of meeting these conflicting demands means that the Army is likely to lose popularity during a Sisi presidency, undermining government stability. While Egypt's public finances are expected to remain under pressure, the authorities' reform measures and stimulus plans are aimed at gradually reducing the fiscal gap and jump-starting the beleaguered economy. Egypt's foreign reserves have broadly stabilised, with Gulf aid providing the underlying support. But, contractors face severe non-payment risks until Egypt's aid dependency is resolved. The country's energy bill should be less of a burden with low global oil prices expected in the two-year outlook and, therefore, a reduced drain on the foreign reserve position, while providing some relief to public finances. Meanwhile, Islamist-backed IED and shooting attacks are likely and a two-front Sinai and western Egypt insurgency is a risk.

## Turkey

The consecutive re-elections of the Justice and Development Party (Adalet ve Kalkınma Partisi: AKP) in 2007 and 2011 brought stability and continuity to Turkish politics. An authoritarian trend in recent years and a concomitant rise in societal polarisation have eclipsed the party's positive track record. President Erdoğan, the party's founder, is now likely to exploit the popular momentum he gained following the failed coup on 15 July 2016 and push for constitutional changes providing the presidency with executive power, further straining societal tensions.

The AKP government is likely to continue exploiting the 15 July coup attempt to purge the military, judiciary, and state bureaucracy from political opponents. Although Erdoğan remains unlikely to de-escalate Turkey's fight against the Partiya Karkerên Kurdistan (PKK), the military's loss of morale and the post-coup purges are likely to undermine its fight against the militant group, while rendering the top command more pliable to Erdoğan's wishes. There is a risk of high-casualty attacks by the Islamic State and PKK affiliates in Istanbul and Ankara.

Turkey's short-term sovereign risk is supported by a declining current-account deficit and high official reserve levels. Low public debt and reasonable fiscal deficits also support a fairly benign short-term risk. However, the outlook for the rating is Negative, reflecting liquidity pressures, which could dramatically intensify should net capital inflows turn sharply outward. The biggest short-term risk to liquidity is a potential reversal of these capital flows.

## Israel

Prime Minister Benjamin Netanyahu's right-wing government coalition is likely to prioritise anti-terrorism efforts and the maintenance of the status-quo, to the detriment of relations with the Arab-Israeli and Palestinian populations. Israel's missile defence systems are likely to intercept most rockets from Gaza. Hizbullah, however, is likely to be able to fire rockets at rates that would at least partially overwhelm their capacity, indicating a severe risk in the event of another Israel-Hizbullah war in Lebanon. This is unlikely in the one-year outlook due to mutual deterrence, although there remains the potential for escalation through miscalculation. Coalition partners are likely to pressure Prime Minister Netanyahu to extract support for their special interests, including controversial policies such as expansion of settlement construction and curbs on NGO activity. Government efforts to politicise the institutions of state, including the judiciary and armed forces, are likely to prompt increased social unrest between Israel's left-wing secular tradition and right-wing and religious activists.

Israel's short-term sovereign credit risk is very low. Substantial foreign-exchange reserves and a healthy current-account surplus help to minimise the risk to Israel's external liquidity position and solidify Israel's financial footing. Short-term external debt for the private sector is somewhat high, but can usually be rolled over fairly easily.

## Jordan

The US and Gulf states are invested in Jordan's stability, given its location, moderation, and counter-terrorism capabilities. The 20 September elections will likely again produce a parliament pliant to the royal court and there is no opposition capable of threatening the power of King Abdullah II. Jordan's economic weakness and the strain from Syrian refugees are key long-term threats.

Jordan's weak financial position has been exacerbated by the refugee crisis, making payment delays and localised economically motivated protests likely. Economic growth is likely to remain weak in 2016-17, as a result of fiscal retrenchment and regional and domestic political uncertainty. Nevertheless, the US and allies will probably provide sufficient financial aid to the Hashemite monarchy to prevent persistent or coordinated protests from becoming destabilising. Inter-state war with Israel or Syria is unlikely, although skirmishes along the Syrian border are probable. The conflicts in Iraq and Syria are increasing the IED capabilities of Jordanian jihadists. Recurring strikes are likely to affect ports, phosphates, transport, and manufacturing.

## Saudi Arabia

The division of power between the crown prince, in charge of political and security affairs, and deputy crown prince, overseeing everything else, is unlikely to change in the six-month outlook. The latter has positioned himself as a change agent, willing to marginalise the ruling family and the clerical establishment's influence over government. The monarchy's priorities are to contain an Islamic State insurgency, ensure the clerical establishment remains supportive, and deliver economic growth. Should the economic slowdown adversely affect youth employment and the monarchy's ability to redistribute patronage, the risk of a serious threat to state stability emerging over the coming year would grow sharply. The Islamic State campaign has progressed to more ambitious attacks on security force targets. Successful attacks on secure assets remain unlikely.

Saudi Arabia's short-term sovereign credit currently faces limited risk, with its rating underpinned by its vast petroleum reserves and strong external finances. The government has accumulated large reserves of hard-currency and the country has huge additional liquid assets overseas. The weak oil price outlook will continue to pressure Saudi Arabia's external balances over the next 12 months, but the kingdom is expected to lean on its significant financial buffers to manage through the low price environment. Moreover, the sovereign's high-quality credit rating allows it easily to meet any short-term financing needs by readily tapping international capital markets. ■

**About IHS Economics and Country Risk**

*IHS ECR leverages the company's detailed qualitative and quantitative analysis of 204 countries, covering political, economic, legal, tax and security risks.*

*Intelligence cut-off date: 4 October 2016.*

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# The changing dynamics of risk in sub-Saharan Africa

By Michael Creighton, head: export credit finance, Nedbank Corporate and Investment Banking

## Optimism towards sub-Saharan Africa

Recent years have seen an enormous amount of optimism towards Africa, both internationally and within Africa. Ex-President of the African Development Bank, Donald Kaberuka, has made reference to Africa's Lions joining Asia's Tigers. Kingsley Chiedu Moghalu made the following comments in his 2013 book, Emerging Africa, "... global investors are increasingly paying attention to a continent once dismissed as 'hopeless' but today regarded as the global economies 'final frontier'". The reference to hopeless continent comes from the cover of the *Economist*, which in May 2000 described Africa as 'The Hopeless Continent', but a decade later (late 2011) the *Economist* title had radically shifted and the new title was 'Africa Rising'.

Much of this optimism stemmed from the impressive growth rates experienced by many African countries over the recent years together with improvements in democracy, less internal civil strife and better governance. Africa's largely young population and growing middle class were viewed as a huge opportunity for continued growth and development.

## Challenges facing sub-Saharan Africa

The last two years have however seen a tempering of this optimism.

Regular incidences remind us of the fragility of democratic institutions. Even countries well respected for their democratic stability, have shown vulnerability at times. Then there are of course important markets and significant economies where true democracy is questionable. On the other hand the large economies of Nigeria and South Africa have shown a degree of democratic maturing as evidenced by recent election results.


Michael Creighton

Corruption continues to be a concern, evidenced by talk of 'state capture' in South Africa and the 'tuna bond' scandal in Mozambique. Certain leaders such as Buhari in Nigeria and Magufuli in Tanzania are however making strong efforts to address this. Terrorism remains a threat, particularly in countries such as Kenya and Nigeria. Unemployment is high, as is the scale of poverty.

The obvious challenges relate to the current economic conditions. Low oil prices and the downturn in the commodity cycle in general, have highlighted the overdependence on natural resources. Growth rates have declined rapidly with the World Bank now predicting only 1.6% growth in sub-Saharan Africa in 2016. Most countries are experiencing a concerning rise in debt and currency depreciation, and declining hard currency reserves have created currency inconvertibility concerns; Ghana, Angola and Nigeria are prime examples. Power shortages and lack of infrastructure continue to create problems for the continent.

## Current state of export credit finance in sub-Saharan Africa

Despite the increasing concerns, export credit finance continues to play an important role, with on average $1 billion to $2 billion of deals being done per quarter. However, a look at quarterly statistics since 2014 provided by *TXF*'s tagmydeals, do reflect a slowdown in export credit finance since Q4 2015 (see chart below).

The majority of transactions being completed in the region are in the infrastructure, power and transportation sectors. Not surprisingly, the power sector has been the most active sector in 2015 and the first half of 2016. This is reflective of the huge power shortages across the continent and the fact that power is critical to ensuring sustainable growth. In January 2016, during the World Economic Forum in Davos, Hailemariam Desalegn, Prime Minister of Ethiopia, said the following: “Africa has huge opportunity and it is becoming a global pole for growth. Energy is the main challenge in Africa. The challenge is to have a quality, reliable energy source that makes industrialisation possible.”

In 2014, the three most active export credit agencies (ECAs)/multilaterals in Sub-Saharan Africa were US Exim, ECIC (South Africa) and CESCE (Spain); in 2015, SACE (Italy), Decredere Ducroire (Belgium) and JBIC (Japan) and for six months in 2016, MIGA (multilateral), US Exim and CESCE (Spain). The top three markets that were beneficiaries of export credit finance in 2014 were Ethiopia, Ghana and Angola; in 2015 it was Zambia, Angola and Ghana and for the first half 2016, South Africa, Angola and Gabon (*All information provided by TXF, tagmydeals*).

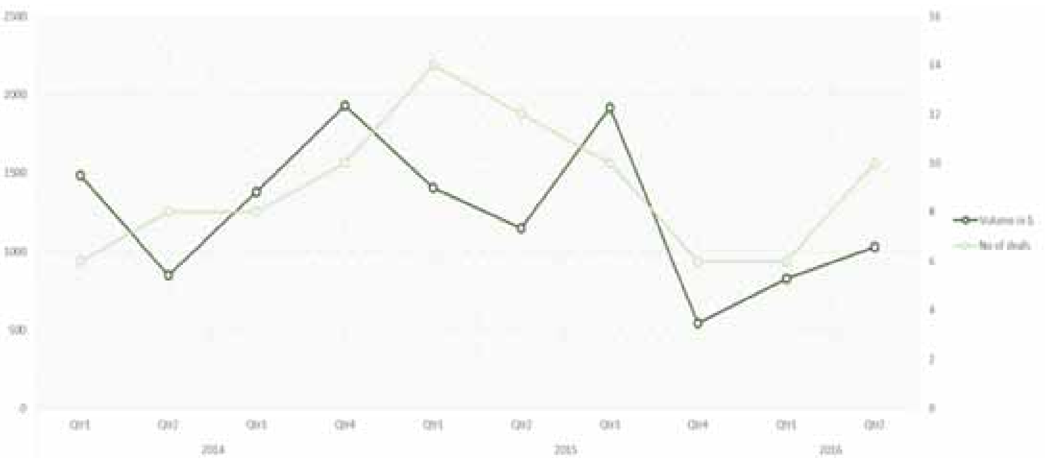
## Challenges to export credit finance in sub-Saharan Africa

The political, social and economic challenges highlighted earlier have started to impact on transactions. Credit committees are increasingly raising concerns regarding the viability of projects and the ability of governments to maintain payments, resulting in an increasing degree of selectivity in approved transactions. This seems to be evident across the board both with insurance providers and lenders.

These concerns are not without justification. An increasing number of completed transactions have started to experience difficulties. Entities associated to the oil and gas and broader resource sectors are experiencing cash flow difficulties. We have seen service providers to the oil and gas sector losing contracts or having their margins cut as the oil and gas companies demand lower costs in an attempt to adjust their businesses to a low oil price environment.

Currency is an increasing area of concern. Dollar funded public-private partnerships (PPPs) where offtake agreements have been signed with utilities that earn revenues in local currency, are starting to wobble as the utilities find themselves having to fund dollar debt with less revenue thanks to local currency devaluation. Lack of supporting infrastructure associated with new projects has created problems. Projects have been completed in certain regions, but are not able to operate at their maximum due to limitations in the supporting infrastructure that, although it was anticipated, have not been completed by project completion date. While offtake agreements may have been signed on a take or pay basis, the requirement of the utility to repay debt when

**Export finance deals 2014 - 2016 (Q2)**




Source: TXF, Tag my deals

revenues are not maximised, adds further strain to the financial performance of the utility.

General hard currency shortages in many markets are causing delays in payments, highlighting currency inconvertibility risks. Rising debt and concerns raised by the IMF are resulting in a reducing ability of Ministries of Finance to issue guarantees or directly borrow for the development of projects. However, in many countries, the state-owned companies fail to provide financial information, or if they do, the financial information is outdated and potentially of poor quality, making it very difficult for lenders and ECAs to approve transactions without the involvement of the Ministry of Finance. This increasingly causes delays in projects reaching financial close.

The regulatory environment in many countries is still inadequate. This is especially evident in the power sector where the regulation around Independent Power Producers (IPPs) and the Power Purchase Agreements (PPAs) are inconsistent. Some countries have frameworks of world-class standards in place, while in others the standards are lacking.

While a more cautious approach to the funding of projects is being adopted by international players, the general view is that there remains plenty of funding available, the key problem is inadequately structured projects.

### Outlook for 2017

Export credit finance will continue to be an important source of funds in Africa, despite the challenges facing the continent, which are likely to continue for much of 2017. In fact, with the current challenges, the involvement of commercial and political risk insurance will become increasingly important. The challenges will force governments to be more selective in their choice of projects. In addition, lenders and insurance / guarantee providers will be more cautious in the transactions that they support. Only the well-structured projects are likely to progress and those that involve well-respected players. For example, transactions that include internationally respected development financial institutions (DFIs), financially sound and experienced project sponsors and EPC contractors and involve high government commitment, are more likely to be able to attract the necessary funding.

The interest in power will continue but with an increasing focus on renewable energy. South Africa has been at the forefront of implementing successful renewable energy projects, but the interest is expanding across the continent. New markets are likely to attract increasing interest as financiers look to diversify their portfolios away from the

**Regular incidences remind us of the fragility of democratic institutions. Even countries well respected for their democratic stability, have shown vulnerability at times.**

historical big markets that are experiencing a higher degree of problems to markets performing better and where exposure is lower, such as Ivory Coast and Senegal. Countries along the east coast of Africa will most probably receive more interest influenced by their lower resource dependence. Mozambique, despite its problems, will be a market that will attract much attention in 2017 as various infrastructure and gas projects progress.

Governments, together with international institutions, will try and improve the governance and performance of utilities so that they can start borrowing without the need for government guarantees. Efforts to diversify economies away from resource dependency will gain momentum, with a strong focus on agriculture. Due to the weak private sector in many jurisdictions, it is likely that governments will be active in these diversification initiatives.

ECAs will continue to play an important role, however the involvement of multilaterals such as MIGA, African Trade Insurance Agency (ATI) and The Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC) as well as private insurers will be more prevalent.

While the current situation in Africa is challenging, the long-term prospects for the continent remain positive and in time the optimism of a few years back should return. Certainly Nedbank remains committed to providing ongoing export credit finance in Africa. ■

# Demand for export credit and political risk insurance

**By Professor Andreas Klasen, Offenburg University, and Dr Simone Krummaker, University of Westminster**

Doing business with and in other countries is vital for the growth of companies of all sizes and sectors. But in addition to business opportunities for internationally active companies through trade and foreign direct investment, exporters and investors operate in an environment characterised by heterogeneous political systems, economic conditions and cultural behaviour. When firms export their products and services or set up foreign manufacturing operations, they are exposed to several dimensions of risk: Political risk, commercial risk, currency exposure as well as cross-cultural risk. Exporters often require insurance cover for political and commercial risks linked to export transactions (Klasen, 2014). Export credit agencies are important to mitigate negative trade effects of financial constraints due to market failures (Badinger and Url, 2013). Political risk insurance is a risk mitigation tool foreign direct investors regularly use.

Recognising that risk aversion and risk mitigation as the only motive is not adequate, several authors have provided a theory following evidence that firms purchase substantial insurance amounts (see, e.g., Mayers and Smith, 1982). This theoretical framework about insurance demand in general has been extended and tested by a number of authors with empirical studies on corporate demand (see, e.g., Hoyt and Khang, 2000). However, it is still not yet well understood what drives the corporate demand for insurance due to difficulties in data availability and challenges in measuring the theoretical constructs (Krummaker and Schulenburg, 2008). There is also limited evidence on the question why exporters and foreign investors use export credit and political risk insurance as an essential risk mitigation tool.


Andreas Klasen

## Background and research design

Due to this research gap, the international research project *Demand for Export Credit and Political Risk Insurance* has been launched in 2015. The project conducted by researchers from Offenburg University, the University of Westminster and the London School of Economics and Political Science (LSE) follows an explorative qualitative approach and an explanative quantitative approach, both informing each other. Data were collected via open-ended interviews, via a survey with qualitative and quantitative questions, as well as from annual reports. Multiple rounds of qualitative data collection via interviews run simultaneously with the collection of data via questionnaires. This empirical study was conducted with more than 35 export credit and political risk insurers in both public and private forms. The selection of insurers was driven by the aim to include a variety of suppliers from different countries but also to cover both public agencies and private commercial insurers. It was the intention to cover organisations from different cultural and national backgrounds but also from more mature to young insurers. The participants of each insurer was the CEO, COO or Managing Director.

## The rise of geopolitical risk

Geopolitical risk is in the core of export credit and political risk insurance. The evidence indicates that there is a strong relationship between the demand for coverage against those risks and the perceived or actual risks. These findings are supported by the results of the survey, in which 65% of the respondents expect political risk to increase. Additionally, being asked to name the top five of the most important risks to the global economy, the most often mentioned risk was the risk of geopolitical conflicts, followed by a recession in China and volatility in oil and commodity prices. It can also be seen from the data that the country rating influences the opportunities for importers. In countries with lower ratings, investment and financing is more difficult and comes usually with additional requirements. Credit export and political risk insurance can alleviate some of these issues. Companies intend to complement private credit insurance with government offerings, and government export credit agencies and political risk insurers can be regarded as insurers of last resort.

### The importance of financing

In export credit and political risk insurance, the question of how the transaction is financed is often tightly associated with the requirement to transfer the export credit or investment risk to a public or private insurer. Thus, the bank which finances the transaction plays a decisive role in the demand for coverage against these risks. The role of the financial intermediaries is also emphasised in the topic of financing for SMEs. Several statements in the interviews describe that external financing for SMEs is more difficult than for larger companies, which often have long and active relationships with several banks. Some arguments also point out, that the 2007/8 financial crisis has made it even more difficult for smaller companies to obtain substantial financing via banks. Statements also emphasise that SMEs actually would benefit even more from risk transfer via export credit or investment insurance. As these companies have less expertise in dealing with these instruments, financial intermediaries could take the role in advising the companies and to connect the financing of export trade with the financing question.

### Signalling and stakeholders

The interviews reveal that many exporters and foreign investors are concerned about the impact of the risks of international trade on the firm's balance sheet. The key reason here is to avoid earnings volatility, as this is in general considered to be a feature of risky

**When firms export their products and services or set up foreign manufacturing operations, they are exposed to several dimensions of risk: Political risk, commercial risk, currency exposure as well as cross-cultural risk.**

firms. This motive is closely connected with the factors of signalling to stakeholders. Insurance is assumed to be a means of signalling risk of the company to markets and stakeholders, as companies with insurance contracts will have a lower earnings volatility due to insurable unsystematic risk.

### Regulation

A further trend showing is regulation with 75% expecting a high or very high impact on trade. This is also reflected in the data from the interviews. Tightened regulations and rules internationally are expected to make foreign trade for companies more difficult and therefore will have an impact on the demand for insurance. Both international and national regulatory regimes influence demand and, in particular, higher banking regulation negatively impacts the availability of small ticket loans. Preliminary results also show that global standards as well as harmonised products and policies affect demand, and national content policies play an important role for government export credit insurance.

### SMEs as key customers

One of the most mentioned reasons influencing the demand for export credit and political risk insurance is the size of the company. According to the empirical data, company size impacts the demand through three main factors: Transaction cost of risk management, knowledge and diversification. Another argument was that larger companies have more weight in negotiating the terms of an insurance agreement. Nearly all of the interview participants mentioned that SMEs have a higher need than large corporations to cover risks associated with international trade via insurance agreements.

For example, the interviews show that

larger companies have more professional risk management or finance functions. They also have more knowledge about markets for risk and financing products available. This factor can also be labelled as transaction cost of risk management, because the effort to build up a risk management and the related knowledge is not increasing proportional to firm size. Once a growing company has installed such a function, the benefits are that more resources and knowledge are available to manage risks efficiently. In smaller firms, the insurance portfolio is often managed in the finance, accounting or law department without a dedicated function. Thus, time and knowledge is limited and as a result, smaller firms' often not only lack sophistication but also might let go benefits and opportunities of professionally organised export credit and political risk insurance coverage.

## Trends

Besides factors driving the demand for insurance directly, some more subtle trends were explored asking if and how these trends might shape future trade and therefore the demand to cover related risks. In addition to further financial crises, the respondents are concerned about geopolitical issues, such as shifting of power towards Asia as well as fragile multilateral relationships. Another trend emerging from the survey is digitalisation. 85% of the respondents believe that this will have a high or very high impact on global trade. It emerges from the interviews that export credit and political risk insurers at the moment see changes coming up in how the internal processes and distribution of their insurance products will be made simpler and quicker. No clear picture yet emerges about the impact of digitalisation on trade directly.

## Preliminary results

The project will be completed at the beginning of next year, but there are already several important initial findings emerging from this research. Preliminary results show concepts emerging from the data which enrich the current theoretical landscape on firms' demand for export credit and political insurance. The project will also have important implications for a number of parties involved in export credit and political insurance. This includes private and public insurers, guardian authorities and policy makers. The concept of the size of the company, for example, does not seem to influence the demand of insurance directly, but rather via factors which are a consequence of size effects within companies. The context of financing and risk management for SMEs differs significantly from those in larger or even multinational companies, in particular with regard to restriction on access to finance and limitations on the sophistication of risk management and knowledge. The role of financing institutions is crucial, and regulatory issues have to be addressed in an appropriate manner. Companies seem to expect a level-playing-field, as well as more harmonised products and policies. Furthermore, context factors such as the macroeconomic and geopolitical environment are important. As many participants expect some of these factors to be more volatile in the nearer future, this will have an impact on the demand for export credit and political risk insurance. Furthermore, digitalisation is a key challenge for the industry, and companies expect solutions for new and innovative approaches. ■

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# 2016: The tipping point

**By William Clark, head of UK Trade Credit at AIG**

The 2015 Berne Union statistics for the trade credit insurance market shows an interesting trend over 2014 and perhaps one worthy of note to us all. The numbers suggest that our industry has reached an inflection point during 2015 where claims have reached their highest level since the global financial crisis and total premiums have declined for the first time in some years. This backdrop is prevalent at a time where capacity continues to enter the market according to the Arthur J Gallagher Market Report which shows that the available market capacity in Trade Risks terms grew by some 3% over six months to July 2016.

These latest statistics reflect an increasingly complex market for credit insurers where the traditional tools for dampening losses are measured against new entrants keen to grow portfolios. This picture continues into late 2016 and in a persisting low investment yield environment it is set to stay this way moving into 2017. The cocktail of outcomes will pose challenges for insurers but also some significant opportunities.

## Risk is risk...

Loss activity is at its highest level since 2008, reflecting the unsettled and uncertain geopolitical environment. The list of events that has led us to where we are is endless and truly global in its reach. Political events in Brazil have exacerbated economic pressures and vice versa. The Middle East and North Africa continues to dominate the headlines where the rise of ISIS, the threat of terrorism, mass migration and complicated social and political allegiances put problem-solving on the difficult to impossible scale of plausibility.

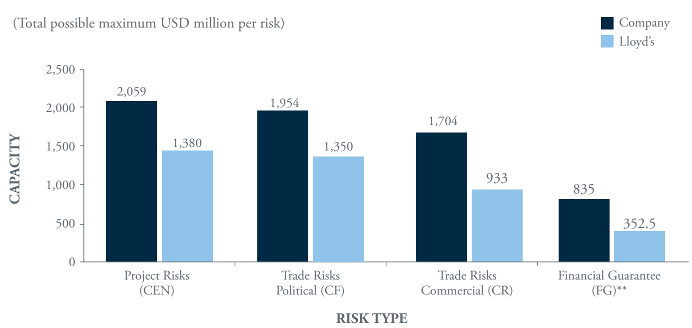
The frozen issue that is Ukraine and Russia lingers. Turkey is clearly undergoing fundamental restructuring in social and political terms that will clearly resonate into the economy. The doubts over the Chinese economy persist and that feeds its nervousness into an already affected commodity market. The South China Sea territorial disputes rumble onwards and North Korea seems intent on developing its nuclear capability.

The migrant issue in Europe, as well as currency union, continues to tax its politicians. "Brexit means Brexit" but at this stage no one can say what it actually means. The USA also goes to the poll booths with a campaign that is as divisive as living memory can serve. Against this backdrop it is little wonder that smaller news items like the India-Pakistan peace talks breaking down, Venezuela, and South African political and social instability, struggle to capture the limelight.

Other substantive issues that often fail to grab the headlines include climate change, growing wealth inequity, the end of the liberalism, the lack of trust in institutions as well as a lack of faith in expert opinion. It is fascinating that Dun & Bradstreet, in their Global Bankruptcy Report 2016, suggested that their Global Risk Index has worsened with 92 countries out of 132 having a worse rating than at the start of 2008.

William Clark

**Available market capacity – July 2016**




Source: AJG CPRI market update for July 2016

It is little wonder therefore that our industry has seen a significant pick-up in losses but its probably fair to say that these losses are not in the same shape or form as they were during the crisis of 2008. If the financial crisis largely impacted the developed economies then the commodity crisis has impacted the developing ones. Berne Union statistics show that short-term credit insurers paid $2.58 billion in claims in 2015, up from $2 billion in 2014, with significant increases in claims paid in markets such as Brazil, Russia, Saudi Arabia, Hong Kong and Mexico.

Moving into 2016, the larger insurers have reported increases or at best flat trends in their loss ratios, reflecting the increase in both claims frequency and severity in a number of markets. The Association of British Insurers notes a surge in the number of insureds claiming on their trade credit insurance policies, with £150 million paid out for customer insolvency or late payment last year, a 42% uplift. The ABI concludes that UK businesses continue to face risks with economic volatility in many export markets.

What is important to note, however, is that these losses are not at the level of 2009 and 2010. Insolvency rates in many markets are seemingly benign driven by low inflation, low interest rates and low energy prices with the exception being those allied to commodities. Insolvency trends are not expected to change materially in 2016 but the usual health warnings have been put out that this could change as governments struggle to find economic levers that will grow their respective economies.

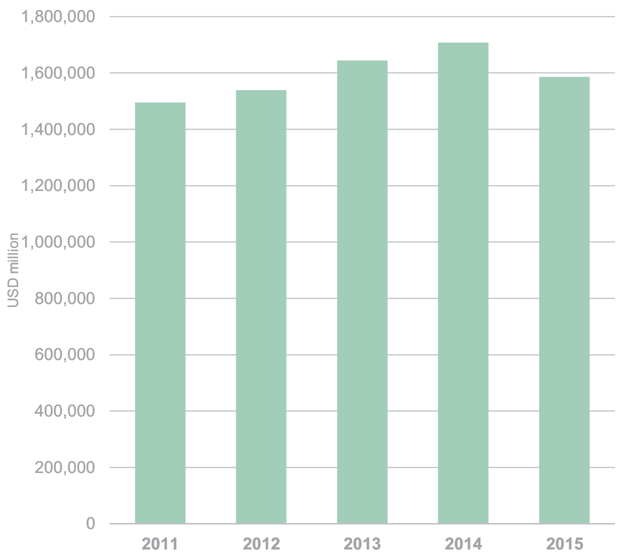
### Its all about trade...

While the market has experienced growth in the overall number of policyholders, at the same time there has been a decrease in global premiums. Of the total business volume, Berne Union stats show a drop in short term export credit insurance between 2014 and 2015 to $1.6 trillion, down from $1.7 trillion. Medium and long-term export credit insurance for periods in excess of one-year amount to over $154 billion, down from $166 billion in 2014 and new transactions in investment insurance (INV) was down to $97 billion, from $99 billion in the previous year.

To some extent this year-on-year decline can be attributed to reporting changes from a large Berne Union member, which has somewhat distorted this year's results. Seeking to exclude this factor however, it is difficult to believe that this decrease can be attributable to a reduced risk outlook. Perhaps part of the explanation lies in the fact that there has been an overall drop in global trade volumes.

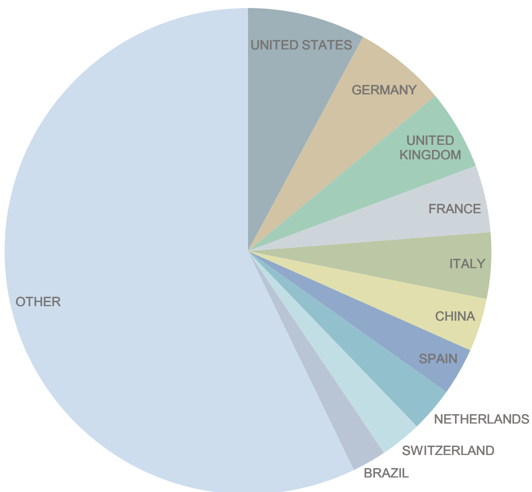
World Trade Organisation figures show that exports shrank by over 10% in 2015, largely fuelled by a 45% decrease in world energy prices. What is interesting to note is that the last negative figure posted in world trade terms was in 2009. More interestingly still is the fact that this figure is against the

### ST New Business – insured during each year




Source: Berne Union statistics

### ST Credit Limits 2015 – top 10 countries




Source: Berne Union statistics

backdrop of anaemic and shrinking growth numbers since 2012.

According to the WTO, growth is set to remain sluggish in 2016 at 2.8%, unchanged from the 2.8% increase in 2015 as GDP eases in developed economies and picks up in developing ones, and as a result of low oil and other commodity prices. Its fair to say that our industry is unlikely to receive any premium dividend in 2016 based on world trade volumes or prices.

There is however euphoria in the market, driven by excess capital and downward pressure on rates in other classes of commercial insurance/reinsurance and asset classes. This has resulted in a surge in players entering the credit space and increasing capacity and available limits.

There are currently over 50 credit markets in London whereas five years ago there were less than 30. Another factor is the transition towards excess of loss (XL) products and single risks where "shared risk" relationships are becoming prevalent. This has naturally lowered barriers to entry.

### Beyond the tipping point…

Given the more challenging operating environment the pressure is on for the insurers not only to add more capacity but to remain committed to the line, as well as continue to innovate and attract new policyholders. There is a recognition that the industry also needs to continue to work on rebuilding its reputation following the financial crisis. It is clear that many clients were lost to our market after 2008 and the trade credit insurance market that emerged from the crisis set a tone.

What has become apparent over the last six to seven years is that customers have made clear their issues with the product and asked for more certainty. Whole turnover insurers' right to reduce or cancel the credit limit on a buyer at any time was exercised frequently during the downturn as carriers sought to react to buyers' credit problems before they worsened. The consequence of this led to the growth of non-cancellable limits as well as limit withdrawal notice periods. This has offered insureds more certainty of cover and greater transparency.

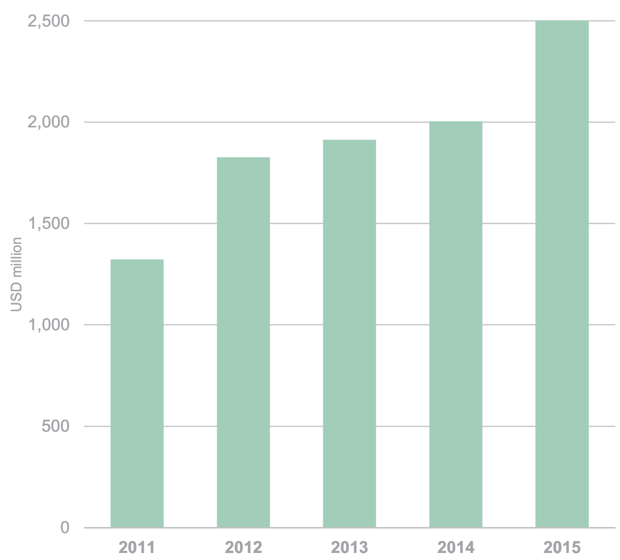
Certainly the growth of XL products has seen a growing cooperation between policyholders and insurers. Insureds are demonstrating a more sophisticated approach to risk management and, in exchange for a robust programme, a willingness to retain their slice of risk.

There is also a growing relationship with the banks and commodity traders where there have been significant changes to policy wording and risks that have yet to be properly tested. Early signs suggest this evolution has not always been to the benefit of credit insurers … or indeed the banks or traders. Our experience in this space over the next year or so will be a journey of change and opportunity.

The next step as the credit insurance market continues its evolution of products and services is how we use technology. It will move from a policy support tool to an omni-channel, client concentric distribution tool. For some of us it would be comforting to feel that this is some way off. However, the arrival of supply chain finance businesses that provide capital as well as technology to control and, importantly, initiate risk is fully up and running.

Blockchain is widely canvassed as the next big thing and it could prove to be a considerable source of disruption as applications are developed for trade finance. HSBC, Bank of America Merrill Lynch together with the Infocomm Development Authority of Singapore are among those currently focusing their attention on automated letter of credit transactions and beyond. For credit insurers today such developments need to be in the SWOT analysis boxes of threat and opportunity. ■

**ST Claims Paid – during each year**




Source: Berne Union statistics

EXPERT ANALYSIS

# Digitalisation: One aspect of the future of short term credit insurance

**By Olaf Lipinski, regional director risk management, Euler Hermes World Agency**

The impact of digitalisation is widely discussed in all lines of insurance. What is the impact for credit insurance?

Let us take a look back, what has shaped and influenced the short term credit insurance industry in the past 20 years? A large consolidation and an extension to a worldwide scope took place. In 1995 every country had two to three national credit insurance companies with limited international scope and only a loose worldwide network to exchange information. Credit limit decisions on overseas buyers took several days.

Nowadays the industry has three large international players and a number of highly specialised niche market insurers. Today's communication with customers and brokers is performed by email and online exchange of limit requests, decisions and assessments of the buyers. Competition is fierce and every player is fighting for market share via excellence in service.

Digitalisation will take communication to a new level. Clients expect more information about the credit limits of buyers and on the markets of the buyers. Access to this information must be any time, and at their convenience.

In an environment of the 'internet of things' or industry 4.0 as it is called in some markets, we see a new level of connectivity between companies. Machines and robots will communicate to each other. It will be important for the credit insurance industry to find solutions to participate in this development. The connection to this new mode of communication will be an important component of future success.

Olaf Lipinsk

In today's world, credit insurers have already established direct links between clients' CRM systems and their own systems. An individual exchange of credit limit requests is no longer required. Once the CRM system identifies the need for an increase in any credit limit, the information is exchanged automatically via the online link without human intervention. This way of exchanging information needs to be developed further. For the moment, connection to mobile devices for example is only at an early stage and could be a major field of development for the future.

Modes of payment may also change in the future. There are already some companies transferring money not only in the traditional way via banks, but by using blockchain technology. This way to transfer money

**Digitalisation will take communication to a new level. Clients expect more information about the credit limits of buyers and on the markets of the buyers. Access to this information must be any time, and at their convenience.**

purely via the internet is just one example of the array of emerging trends, and the credit insurance market needs to understand this new way of payment in order to develop solutions that fit into this new environment.

New developments and technologies do not only require new methods of communication with clients, but also new products. Besides today's whole turnover policies, the market for the cover of single transactions will develop and grow into a larger share of the total market. Single transactions, however, require new and different pricing models. Managing the concentration of risks is far more challenging with a bigger market share of single transaction cover in the short term credit insurance market.

In the world of the 'internet of things' new sources of information are available, meaning that new connectivity opens the door for new information on market participants. This will change the way credit insurance assesses companies. In today's world, credit insurance players have developed a first-rate system to assess balance sheets, payment records, market sectors and country developments. All credit insurers make great efforts to gather this information and assess the data. The data is stored in a systematic way to allow the combination of automatic and manual assessment. The final assessment is expressed in a rating scale whose quality is verified by the probability of defaults. Already today this information adds up to a huge database.

In the future the importance of the database will increase even further. Alternative databases and assessments of companies outside the credit insurance industry might appear. But the strengths of the credit insurance industry lie in the long track record of interpreting the data and explaining the results to customers. New algorithms are developed outside the credit industry, but an algorithm without expert interpretation will not satisfy the demands of our clients.

Although today's databases are impressive in size, this will not be sufficient for the requirements of the future. The key to success lies in the combination of exploring new data sources by taking the opportunities of the 'internet of things'. In order to develop new algorithms in addition to today's assessment and explaining the results to our customers. Big data analysis gives new opportunities in the assessment of data, which needs to be integrated in the existing assessment systems.

All these challenges require investment in new technology and products. Most of these technologies are at an early stage of development, quite a number will fade away,

**In a world of ever faster changing technologies, however, this competitive advantage might not last for long.**

and only a few will set new standards. Who can say today, which role blockchain transactions will be used five years from now? How big will the market share be? Or will it already be replaced by a different technology? The players in the market have to decide and allocate resources in the development of technologies without knowing if these technologies survive the next decade.

The credit insurer who is the first to find solutions for communication with the clients, develops new products and pricing schemes, and makes advances in big data analysis will have a competitive advantage over its peers. In a world of ever faster changing technologies, however, this competitive advantage might not last for long.

Players in the market need to find ways to allocate their resources efficiently in researching different technologies concurrently. The key to sustainable success will be a constant review of the progress of different technologies, paired with faster decision-making to invest in new technologies, and discontinue old or unsustainable technologies.

This is definitely an interesting challenge for our industry. ■

**New developments and technologies do not only require new methods of communication with clients, but also new products.**

EXPERT ANALYSIS

# The challenge of the trade finance funding gap

**By Marc Auboin, counsellor for trade and finance, WTO**

The availability of trade finance is essential for a healthy and well-functioning trading system. Up to 80% of global trade is supported by some sort of financing or credit insurance. Global and regional surveys undertaken by the ICC, the African Development Bank and the Asian Development Bank, have pointed to the existence of relatively large gaps in provision, particularly in developing and emerging economies where trade is growing at the fastest rate. Total trade finance gaps are estimated to be $1.6 trillion, of which $700 billion is in developing Asia. Gaps exist in all continents, including in Europe.

Other surveys, emanating in particular from business organisations (World Economic Forum), emphasise that in regions such as Africa, the Caribbean or for Pacific Islands, lack of access to trade finance is viewed as the number one or two impediments to exporting. Without trade finance, opportunities for trade, growth and development are missed. Small and medium-sized enterprises are particularly affected, while larger companies are benefitting from the extra-liquidity provided by quantitative easing policies of many central banks.

This is a time to act: first, trade is a dynamic process, in which labour-intensive industries are regularly reallocated in new parts of the world, depending on comparative advantage. Garment factories relocate to countries such as India, Bangladesh, Vietnam, Myanmar and reaching to Ethiopia and Rwanda. The frontiers of

Marc Auboin

international trade are expanding. New links involve new players, investors, and traders. It also requires trade finance.

At the same time, global financial institutions have shown less appetite to do business in developing countries since the global financial crisis of 2009. A large number of correspondent banking relationships have disappeared. Local banks and non-banks in developing countries are not always in a position to fill the gaps, although in the medium-run, one could expect markets to clear.

In the meantime, there is a particular concern that SMEs in developed and developing countries – particularly in the developing ones, face lasting challenges in their integration into global trade. SMEs are known to be leading drivers of trade, employment and economic development. In developing countries, the few alternatives to bank financing such as inter-company lending and factoring may simply not exist. Trade credit insurance may not be available, and the legal framework for factoring may not be in place. As a result, when a bank reject requests for trade finance, SMEs may be left with no alternative but to pay its trade cash, go informal, or find another second-best solution – sometime

**Without trade finance, opportunities for trade, growth and development are missed. Small and medium-sized enterprises are particularly affected.**

the transaction is just forgone.

Action is needed to address these financing gaps. This was highlighted in the UN's Financing for Development Agenda. The WTO Director-General has been issuing a report (Trade Finance and SMEs, available at www.wto.org) looking at these issues in detail. It brings together the recent surveys and research to highlight the scale and geography of the gaps in trade finance provision, considers the actions currently being taken and outlines potential future action.

These actions includes, along with WTO traditional partners in trade finance:

- Enhancing existing trade finance facilitation programmes to reduce the financing gaps, from $30 billion currently to $50 billion. Trade finance facilitation programmes were never designed to eliminate all market gaps, but they allow SMEs and their banks locally to engage in international trade, thereby building capacity and experience. The WTO director-general target is inspirational but achievable.
- Reducing the knowledge gap: we know that part of the financing gap reflects the knowledge gap which exists regarding the use and knowledge of trade finance instruments, be they funded instruments, guarantees, credit insurance. Local financial institutions may lack the human and risk-taking capacity. Professional organizations from the private sector should step up their capacity-building activities. The Berne Union may support this effort – similar to Factors Chain International stepping up training in factoring, and multilateral development banks contributing courses to the newly established International Chamber of Commerce's (ICC) Academy. The objective in the WTO report is to train 5,000 qualified trade finance professionals, in particular in developing countries. Berne Union members may contribute to this objective, and develop courses and training reflecting the special needs of the credit and investment insurance professional. This collective effort is not about training bankers, company treasurers or any other category of operator, but about teaching the best practices (techniques, instruments, regulation, fintech, etc.) in each segment of the profession of supporting financially international trade.
- Maintaining an open dialogue with trade finance regulators to ensure that and development considerations are reflected in the implementation, and eventually design, or regulations.
- Improving the monitoring of trade finance provision. We need to improve the monitoring of trade finance provision to identify and respond to gaps, particularly relating to any future crisis. The WTO will continue to support ongoing efforts of the ICC and Asian Development Bank. The Berne Union may continue to work with other organisations in gathering data, facts and analysis, which may support policy decisions during crunch times.

**Part of the financing gap reflects the knowledge gap which exists regarding the use and knowledge of trade finance instruments, be they funded instruments, guarantees, credit insurance.**

Strong inter-institutional dialogue and coordination will be required to take such action/initiative forward, including with the Berne Union.

On trade finance, the WTO and its partners have the flattering reputation of being able to deliver. Since 2009, the various actors, including the private sector (Berne Union, ICC, Factoring International), multilateral development institutions, and the WTO have been meeting in a consultative group, the expert group on trade finance, to discuss areas of potential cooperation. Under this new WTO-led initiative, let us hope that the Berne Union keeps the same level of mobilisation and partners with the WTO with new ideas and projects. ■

**The frontiers of international trade are expanding. New links involve new players, investors, and traders. It also requires trade finance.**

# Small business is big business for US Exim Bank

**By Jim Burrows, senior vice president of small business, US Exim Bank**

In today's economy, access to global markets is essential for small- and medium-size enterprises. Businesses are increasingly spreading their risks across regions and unlocking flexibility to capture demand as economic conditions shift. The Export-Import Bank of the United States (Exim Bank) equips American exporters with the protection and liquidity to enter new markets and diversify their portfolio of customers. When US companies or their customers are unable to access export financing from the private sector, Exim fills the gap by furnishing American businesses with the tools necessary to compete for global sales

At Exim Bank, we recognise that small businesses form the bedrock of the American economy. In fact, according to the Small Business Administration, small businesses create two out of three net, new private-sector jobs in the United States and employ half of the domestic workforce. Small businesses are therefore critical to what Exim does.

Exim Bank authorised more than 2,300 transactions in financing and insurance for the direct support of American small business exporters in FY 2015, not including support for small businesses in the supply chains of larger exporters. This represented nearly 90% of Exim Bank's total transactions and more than $3 billion in dollar volume.

Yet companies can only leverage Exim support if they are aware of our menu of products, which is why we've redoubled our efforts to bolster understanding of and access to Exim Bank's trade finance solutions. Through digital outreach and on-the-ground regional support, we're educating American exporters more than ever on how Exim Bank can:

- Mitigate the risk of foreign buyer nonpayment, empowering firms safely to offer competitive credit terms.

Jim Burrows

- Unlock working capital, allowing businesses to advance against export-related inventory and accounts receivable.
- Make possible term financing for foreign buyers of US-made capital goods to meet customer demand.

## Digital outreach

As the information journey for businesspeople has evolved, so has Exim Bank's outreach. Over the past two fiscal years, we've forged a significant digital presence to educate small American businesses and connect exporters and exporters-to-be with on-the-ground support and expertise.

We do this by offering digestible digital content covering the fundamentals of trade finance and Exim Bank support. This content primarily assumes the form of eBooks, "How it Works" videos, checklists, and so on. We host webinars for industry- and geo-specific audiences. We're active on social media, where we've increased our follower base by 116 percent over the past two years. By reaching a broader audience and making trade finance more accessible, interactive, and understandable, we can better support the international growth of American small businesses and connect them with the appropriate solution, whether from Exim Bank or the private sector.

Throughout our digital interactions with American exporters, we've also made available clearer paths to consultations with Exim Bank experts. Accessing government support should be easy. We're striving to be as available, responsive and helpful as possible to the small business community. Our local Exim Bank specialists promptly respond to online requests for export consultations. More than 100 of our new small business customers this fiscal year first connected with our team digitally.

Finally, we've ramped up digital outreach to multiplier networks such as economic development organisations, partner agencies, chambers of commerce, lenders and brokers, all of which are often critical steps in an exporter's path to support. The better we serve the community that interacts with our end user, the more we can grow American exports. To that end, we've created a "Digital Toolkit" (http://grow.exim.gov/digital-toolkit) to equip these entities with illustrative trade finance content.

One of the true pleasures of my work is the excitement from exporters learning of our support for the first time – observing the realisation that a deal once thought impossible, a deal that could grow the business and make a meaningful impact on the company and its employees, is now within reach. Our digital presence is making more of these moments possible, and we're looking forward to expanding the projects and the conversations.

### Local support for small, American exporters

Even in the digital age, small businesses need on-the-ground, face-to-face support available in their backyard. Our 12 regional offices, strategically located throughout the country, are dedicated to providing just that support and education exclusively to small businesses at no cost. Offices are staffed with seasoned trade financiers, many of whom have extensive international and corporate banking experience – they've seen it all, and no deal is too small. If a company is exporting US-made goods or service, our team is there to help. And if Exim isn't what the company needs, we will point it in the right direction.

We're continuing our efforts to grow exports from US small businesses through our Global Access Forum events each year. The events familiarise US companies and financial institutions with US government financing and insurance programmes. Local economic development organisations; national industry groups; and a wide variety of business, financial, and governmental partners help bring these resources into communities across America. The forums are town hall discussions – often co-hosted by members of Congress, the Department of Commerce, SBA, the US Chamber of Commerce, and local officials – which provide small companies with insights from existing Exim Bank customers and information on US government tools that can equip them to access foreign markets. Exim Bank recently marked the fourth anniversary of its first Global Access Forum for Small Business, having hosted 93 forums since launching January 2011.

**At Exim Bank, we recognise that small businesses form the bedrock of the American economy. In fact, according to the Small Business Administration, small businesses create two out of three net, new private-sector jobs in the United States and employ half of the domestic workforce.**

To strengthen our relationships with the local organisations that foster small business growth across the country, we recently launched our Regional Export Promotion Program (REPP), a joint effort between Exim Bank and regional organizations with a view to stimulating US export sales. REPP seeks to build on Exim Bank's regional outreach through increased joint marketing and the provision of tailored content, dedicated call-center support for members, a new online portal and lead referral system, as well as a newly streamlined and automated onboarding process. Organisations eligible for membership include local, regional, or state economic development organisations, or World Trade Centres that assist small businesses.

Small businesses fuel American job growth and prosperity. Many powerful government resources are now available to support their expansion, but an "if we build it, they will come" approach simply isn't enough. That is why we at Exim are working every day, on the ground and online, to start conversations with small businesses about boosting that job growth and prosperity. ■

# Small business support: AOFI's support to the development of SMEs, entrepreneurship and competitiveness in the Republic of Serbia

**By Dejan Vukotić, chief executive officer, AOFI**

AOFI is the official export credit agency of the Republic of Serbia established for the purpose of export promotion and development of foreign economic relations. Our aim is to strategically improve business conditions for the Serbian export-orientated economy and overall promotion of the exports of Republic of Serbia.

Exports play an important role in the Serbian economy, influencing economic growth, employment and the balance of payments.

Small and medium-sized enterprises (SMEs) and entrepreneurs are recognised as the backbone of the economy and a key source of economic growth, dynamism and flexibility in advanced industrialised nations, as well as in transitional and developing countries, such as the Republic of Serbia. The SME sector in the Serbian economy accounts for the largest number of active companies, portion of GDP, total exports and imports, and for the majority of employment.

Due to the fact that the world financial crisis had adversely effected the already vulnerable SME sector in Serbia, the government set up a policy framework for SMEs, providing assistance through business support instruments, with a particular focus on which problems they were to address, and the way the instruments are delivered.


Dejan Vukotić

The government of the Republic of Serbia recognised the importance of SME sector, especially export-oriented companies, for the development of our economy. The year 2016 has been proclaimed as "The year of entrepreneurship" and the government has adopted a strategy to support the development of SMEs, entrepreneurship and competitiveness for the period from 2015 to 2020.

Despite the important role of SMEs, which is even more emphasised in times of crisis, the sector is facing significant problems when obtaining necessary financial resources and maintaining liquidity.

It is of great importance for Serbia to secure the development of the SME sector as this will primarily determine the further course of the Serbian integration into the European Union.

AOFI, as one of the instruments of the Serbian government to boost the competitiveness of Serbian exporters in

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foreign markets, recognises that providing support to the SME sector is crucial both in achieving one of strategic aims for AOFI, and meeting the adopted strategy for SMEs and contributing to the overall goal of the Serbian government.

There are several services in AOFI's portfolio by means of which we are able to provide support to the SME sector. In the domain of financing we provide: direct lending, guaranteeing and factoring services. In the insurance domain we provide: short-term insurance against commercial risks, and we are currently developing medium to long-term insurance services.

Being familiar with the needs and obstacles SMEs face, AOFI took steps to assess the sector before we were ready to offer modified services specific to SMEs. Some of them were: to make our services easier to use; to react promptly to requests from SMEs; and make sure our employees are informed and prepared to appropriately handle customers. So far, our services are well recognised by SMEs.

## Case studies

Here are three examples from our practice for provided support to SMEs:

***1. ST insurance against commercial risk***

An SME approached us requesting export credit insurance. The company belongs to the metals industry, and was established in 1992 with 31 employees. The core business of the company is the trade of iron in domestic and foreign markets, and the manufacturing of iron products.

The company had the opportunity to sign an export contract with a foreign business partner. However, the problem for successful realisation of the project was insufficient financing capacity. AOFI considered the client's situation and proposed providing short-term export credit insurance to be used as collateral to the bank to obtain the necessary funds to finance the deal.

The client submitted the request for insurance and we researched the buyer, a Swedish company that manufactures wire products, chains and springs, with 100% ownership of five affiliates worldwide. Two of the affiliates are based in Balkan region. During the process of issuance of the policy we found out that the client will deliver goods to two affiliates of the buyer based in our region. We assessed those two affiliates. Unfortunately, neither of them had sufficient creditworthiness. We made additional efforts in order to support the client and decided to cover the risk with a guarantee from the Swedish owner.

The client achieved a turnover from €1.8 million in 2015, out of which exports amounted to €15,000. Now, with the business AOFI supported, the client will realise the project totalling €1.2 million which will significantly increase the turnover of the client.

The recognised needs of the client in a proper and prompt way by AOFI led to realisation of the contracted business. The issuance of the policy impacted the increase of the volume of export business not only for the client, but also for AOFI and overall for the Serbian economy.

***2. Guaranteeing***

This company was founded in 2007 in Belgrade. It is 100% owned by a private individual. The company is engaged in hydro-works, recording the current status, repair and construction of projects. Much of the construction is on water, under the water, or in hazardous or inaccessible areas.

In April 2015 the company concluded a construction contract with a foreign investor in Montenegro, to carry out construction

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works in a Montenegrin marina, a part of the Portonovi Resort Village. The total contracted value of the transaction amounts to €19.5 million. For the implementation of the work a

**Despite the important role of SMEs, which is even more emphasised in times of crisis, the sector is facing significant problems when obtaining necessary financial resources and maintaining liquidity.**

subsidiary was established in Montenegro. In this business, both companies were acting together as one contractual party. The works should be completed by mid-October 2016. Payment shall be made monthly, for works executed before the 25th of the previous month.

In order to perform the marine construction works, the company was required to provide a performance guarantee in the amount of €1.9 million, which was issued by a bank. AOFI issued a counter guarantee in the same amount, thus allowing for the contracted works to commence.

Until the end of first half of 2016, both companies performed and invoiced nearly 85% of the works, approximately €16.4 million. Out of that amount the companies collected €14.3 million. The majority of the works were realised in 2016. During 2015, the works carried out valued €2.8 million, while in the first half of 2016 the amount of the works carried out was €12.7 million.

Through the realisation of the project, the Serbian company realised the export of services (construction works) amounting to €1.4 million, six times higher than the company's 2014 exports. Indeed the company became predominantly an exporter, with exports amounting to 80% of total turnover. For the period from 1 January 2016 to 30 June 2016 the exported services amounted to €1.7 million which exceeded the level of total exports in the previous year. The realisation of the project resulted in the growth of the company's turnover in 2015 to RSD 230.9 million (€1.8 million) representing growth of 70.5% compared to 2014, with an increase in EBITDA margin to 33.8% in 2015, while EBITDA amounted to 29.4% in 2014. Realised turnover for the first half of 2016 reached the level of turnover at the end of the last year and amounted to RSD234 million (€1.89 million).

The implementation of the project involved hiring an additional workforce, which resulted in both companies engaging 134 workers in order to complete the contracted works. Prior to the conclusion of the contract there were 15 employees.

***3. Lending***

The business activity of this AOFI client is the production of equipment for the distribution of electricity and equipment for electric energy management. It was founded 1992 with 100% private capital. The company is engaged in the production of medium voltage disconnectors.

With continuous innovation and significant investments in development, the client introduced in its production program pole substations, medium voltage disconnectors, modern composite insulators for networks of medium and high voltage, etc. All products are made out of high quality materials, tested by both domestic and foreign institutions. The company was selling the majority of its products domestically, while exports accounted for 20% of its turnover.

Having recognised the export potential of the client, AOFI supported the client's business in Tanzania in 2014. The deal included the delivery of silicon insulators. The value of the contract was over €2 million. Since the client needed funds for the realisation of the export business, AOFI approved a short-term loan in the amount of €900,000.

AOFI's support saw company turnover increase by 111%, from RSD242 million (€2.1 million) in 2013 to RSD512 million (€4.23 million) in 2014. Export revenue grew from €450,000 in 2013 to €2.2 million in 2014. Company profits grew from RSD23 million (€200,000) to RSD106 million (€876,395) in 2014. The share of exports in total turnover increased to 50%.

Based on our experience and the assessment of the needs of SME sector, we found out that the critical precondition is to ensure proper communication with clients, understand the day-to-day obstacles they meet, provide simplified access to services and offer them the most appropriate service in a timely manner. ■

EXPERT ANALYSIS

# The opportunities and challenges of Iran's post-sanctions era

**By Michael Sobl, trade & export finance, DZ-Bank**

Iran suffered massively from the economic sanctions imposed by the United States and the European Union. The Iranian oil and gas industry was especially badly impacted, with oil revenues collapsing from approximately $118 billion dollars (2011) to around $42 billion (in 2013).

For more than 10 years of doubts and long negotiations about the non-military purpose of the Iranian nuclear programme, the UN Security Council (USA, Russia, China, France, Great Britain) as well as Germany, Iran and the EU, agreed in the summer of 2015 a comprehensive plan to end the dispute, and signed the so-called Joint Comprehensive Plan of Action ("JCPOA").

The aim is to prevent the possible construction of an Iranian nuclear bomb and to ensure the exclusively peaceful use of nuclear energy in Iran. The Islamic Republic had to reduce their centrifuges to around 6000 and to reduce the stocks of enriched uranium drastically.

In January 2016, the International Atomic Energy Agency (IAEA) confirmed that Iran has taken first steps to dismantle their nuclear programme. This automatically led to the so-called "implementation day". In a consequence several sanction relaxations took place, as agreed in EU resolutions of 2015. However, the sanctions are only partially lifted. A series of sanctions, including for example the sale of heavy weapons, still remains in place for a few years.


Michael Sobl

While the EU sanctions against Iran were eased, the US sanctions must still be observed. Those trade restrictions for US persons or non-US persons who are "owned or controlled by a US person" continue to exist – with a few exceptions.

When it appeared that after a long period of negotiations the sanctions would be eased, many exporters intensified their sales efforts in order to get a head start with important contracts. Without sanctions, Iran will once again have access to many industrial goods and freely be able to sell oil on the world market. Many Western countries are waiting to be able to do business with the Islamic Republic again.

Following the European Union's ease of their Iran-sanctions earlier this year, several ECAs have reactivated their cover policy towards Iran. At the same time, banks have started their business again. This began with Iran's connection to SWIFT and continued

**While the EU sanctions against Iran were eased, the US sanctions must still be observed. Those trade restrictions for US persons or non-US persons who are "owned or controlled by a US person" continue to exist – with a few exceptions.**

with trade finance products, such as simple remittances, document collections, letters of guarantee (LGs) and letters of credit (LCs). It has to be mentioned, that there are big policy differences between the banks. In the past some banks were severely punished and thus are reluctant to do any business in Iran at all. Others more actively promote their delivery capability.

The most significant barrier continues to be the remaining US sanctions. This leads to a certain dilemma for banks to follow the European rules on the one hand, while they also have to obey to the US rules. This can somehow be compared to the Helms-Burton act vs. several EU resolutions that doing business in Cuba made difficult. But that is another topic.

With the above mentioned trade finance products the banks do not yet satisfy exporters' needs. What is needed is taking Iran risk. That would mean confirming LCs and to provide ECA-covered loans. So far, no banks have established significant credit lines for Iran. As long as no lines are established, no ECA facilities would be feasible.

Initial transactions would be limited probably to country risk assets, meaning a state guarantee to be issued by the Ministry of Finance would be necessary. In such a case the MoF could divert transactions to specific industries. Most likely that will be infrastructure.

Meanwhile some third-country banks open LCs in favor of EU-banks, which they in turn can confirm. However, such transactions must comply strictly to the requirements that still remain, since even the EU sanctions have not been lifted completely.

One of the biggest fears is still the fact that the so-called snap back clause could enter into force. This clause has been included in order to reactivate possible sanctions, if Iran would disregard for example restrictions with regard to their nuclear program.

An eight member panel (called the Joint Commission) has been created, to serve as a dispute resolution mechanism. The members of the panel are the five veto-wielding members of the Security Council, plus Germany, Iran and the European Union. If a majority (5) finds Iran to be cheating, the issue is referred to the Security Council. No single country has a veto. The language of the nuclear deal says that the vote in the Security Council would not be to reimpose

**Following the European Union's ease of their Iran-sanctions earlier this year, several ECAs have reactivated their cover policy towards Iran. At the same time, banks have started their business again.**

sanctions. Rather, the Security Council must decide whether or not to continue lifting the sanctions. And if they fail to do so, the old sanctions would automatically resume after 30 days (snap back).

This framing obviates the prospect of a Russian veto, and it all but assures that if the Western countries believe that Iran is cheating, sanctions will automatically be re-imposed. Such a snap back provision could last for 10 years. It is understood that the snap back would not affect contracts agreed during the period where no sanctions applied.

It also has to be noted that due to a decade of financial and economic isolation, the Iranian banking system also suffered immensely. Besides fundamental economic challenges, basic banking problems – such as corruption, a "high" percentage of non-performing loans, weak central bank liquidity and illiquidity of banks, banks' inability to follow modern standards for financial disclosure, taxation, capital requirements and due diligence – have still to be resolved. Not surprisingly, foreign banks are not rushing into Iranian markets at the rate many expected. ■

**One of the biggest fears is still the fact that the so-called snap back clause could enter into force. This clause has been included in order to reactivate possible sanctions, if Iran would disregard for example restrictions with regard to their nuclear programme.**

# The outlook for the Iranian market

**By Arash ShahrAeini, board member and deputy CEO, Export Guarantee Fund of Iran (EGFI)**

Eight months after the implementation of the Joint Comprehensive Plan of Action (JCPOA) on 16 January 2016, Iran's oil sector has been able to regain access to some of its markets in Asia and Europe. According to the official reports, Iran's oil export to Asia in June 2016 has doubled since the previous year, reaching its highest level since 4.5 years ago

China, India, Japan and South Korea have in total imported around 1.7 million bpd in June 2016 and Iran's oil exports to the Asian emerging markets is expected to increase in the coming months. Although the issue of volatile oil prices is still a serious concern for the oil exporting countries, the success of the Oil Output Freeze plan will make a contribution to bringing back the stability.

On the other hand, the government authorities have made considerable progress in restoring macroeconomic stability under difficult circumstances. As a result, inflation has declined from 45% in 2013 to around 8% in 2016, the foreign exchange market has stabilised, and some key reforms have been instituted. In addition, the country's economic growth has reached 4.4% in the first quarter of the Iranian current calendar year (20 March 2016- 20 June 2016) comes from the recession of 2012 and 2013 caused by the severe impacts of sanctions.

The implementation of the JCPOA bodes well for the current outlook. Increased oil exports, along with lower costs of trade and financial transactions with the Iranian banks reconnecting to the international financial system, would all support the economy to experience a real GDP growth of 4–4.5% over the medium term as projected by IMF.

Arash ShahrAeini

Thanks to the measures taken by the government to improve the macroeconomic environment, all indicators are now moving in favour of the growth of the country's economy and investment. This lays the ground for the country to pursue its ambitious yearly plan to absorb $50 billion in the form of foreign direct investment, foreign portfolio investment, and other debt instruments during the country's next Development Plan. To this end, The Export Guarantee Fund of Iran (EGFI) as Iran's official ECA, whose national mandate is to support the country's out-bound export credits, is to help the country reach this aim by cooperating with other ECAs.

In line with the government's economic policies, the Central Bank of Iran has managed to rejoin SWIFT, reintegrate the Iranian banks to the international financial systems by establishing 472 correspondence relations with banks around the world, create a framework to combat money laundering and the financing of terrorism, improve its supervision over the risk management practices in banks and their compliance with

**Thanks to its sound economic conditions of the early 2000s, Iran became the number one recipient of long term financing in the world as the exposure of major ECAs on the country reached $30 billion in 2007.**

international standards such as the Basel requirements and to increase the banks' capital.

However, with all the measures taken so far, Iran's banking system still faces challenges. Major European banks are still reluctant to re-establish their banking relations with Iranian banks, as their stakeholders are concerned about the probable punitive reaction of the US's Office of Foreign Assets Control (OFAC). However, Iran is trying to get letters of comfort from the OFAC to assure the said banks that they will not face any probable consequences if they decide to resume their banking relations with Tehran.

Thanks to its sound economic conditions of the early 2000s, Iran became the number one recipient of long term financing in the world as the exposure of major ECAs to the country reached $30 billion in 2007. Meanwhile, Iran's public and private sectors are well aware that it is difficult to reach the same international standing without removing the concerns of foreign financiers and investors. But with more than 50 years of positive experience of ECAs working with Iran, there is an optimistic outlook for the future.

There have been quite few cases where Iran has had payment defaults which were not due to an unwillingness to pay, but were due to restrictions caused by the sanctions. Since the implementation of the JCPOA, most of Iran's outstanding debts have either been re-paid or re-scheduled. It can be concluded that with an effective risk management, a more positive cooperative environment can be expected in future. ■

**Thanks to the measures taken by the government to improve the macro-economic environment, all indicators are now moving in favor of the growth of the country's economy and investment.**

# Trade and export finance in Brazil: Outlook and challenges

**By Marcelo Franco, chief executive officer, Agência Brasileira Gestora de Fundos Garantidores e Garantias (ABGF) and Pedro Carriço, executive manager, international credit assessment**

The last two years have been a time of important shifts for Brazilian exporters. After a decade of almost uninterrupted rising commodity export earnings, Brazilian basic materials suppliers saw their sales overseas diminishing considerably from 2013 onwards. At the same time, even though the Brazilian currency depreciated from overvalued levels, capital goods exports from a historically active industrial sector have not yet been able to recover the share in total exports recorded before the commodity boom. Successive increases in manufacturing workers' earnings, and lagging productivity growth, led to rising unit labour costs since 2011, which were only reversed – and solely in US dollar terms – halfway through 2015. Since most Brazilian industrial firms focus on the domestic market and use exports as an opportunistic adjustment mechanism, it is understandable that an improvement in unit labour costs in foreign currency has not resulted in a large change in their total production and exports. Nevertheless the fact remains that as the favourable terms of trade have reverted back to the long-term mean, Brazilian foreign trade has adjusted more slowly than was hoped.

The economic slowdown that held our attention for almost two years is partly to blame for this delayed reaction, but other structural factors contributed as well. Unlike commodity producers, the manufacturing industry's engagement, or even re-engagement, of export markets is notoriously difficult, especially in an increasingly competitive world economy with established global supply chains that are suffering from demand scarcity and productive overcapacity. The manufacturing sector also tends to concentrate a larger number of smaller companies than the commodity segments of the economy whose producers can also count on the sales facilitation provided by trading companies for their exports. Furthermore, small medium enterprises (SMEs) in Brazil seldom have strong in-house expertise or the experience necessary to deal with the complex process of exporting. As a result, the five hundred largest exporting companies account for 80% of all Brazilian exports, leading to the conclusion that there is a significant untapped potential for SMEs to diversify their client base and contribute to foreign trade volumes.


Marcelo Franco

The challenge, as in other parts of the world, is how to provide, in a cost-effective way, the instruments SMEs need to successfully target overseas markets. Short-term export finance in Brazil has traditionally been provided by official banks with vast nationwide networks of branches. Yet even with their mandates to finance exports, these institutions cannot always service SMEs wishing to sell abroad to potentially riskier clients because of the combination of operational costs, lack of security and expected losses. Past experience shows that this financing gap will persist even as the return of economic growth brings down interest rates and rekindles banks' risk appetite, justifying the formulation of a public policy action to correct what can be deemed as a market failure. In this sense, a SME export credit insurance scheme was introduced in 2015. The product met with good acceptance and has gained traction by using the official bank's extensive network and client knowledge as well as a simplified process based on online interaction between exporters, bank branches, and ABGF. Incidentally, greater contact with SMEs has also led ABGF to begin evaluating the possibility of providing overseas market prospection support.

The experience of rolling out the SME product also uncovered another gap in the Brazilian trade finance market. Given the difficult liquidity conditions in the financial system and worsening global risks, local private short-term export credit insurance providers were forced to turn down cover for some clients' export markets. An opportunity presented itself for ABGF to grease the wheels of trade finance by sharing risks with local short-term insurers when there is perceived room for official support to fill the gaps that arise in periods of extended stress.

Another financing gap that stymies the participation of some firms in export activity is the difficulty they have to contract bank guarantees or surety bonds when these are demanded by foreign buyers. Some industries are more prone to face this obstacle than others: defence contractors, for instance, due to banks' compliance policies. Also, some solid soft commodity exporters burdened by foreign currency denominated debt fell victim to the credit crunch and devaluation that hit Brazil in the last two years. Long-term contracts for foreign sales helped to balance cash flow needs of these Brazilian enterprises while their domestic operations manage through a slowdown. The needs of these companies have opened the door to the creation of products to assist new clients from industries up to now unknown to ABGF.

On more familiar ground, larger corporate entities, that have traditionally made use of official support for exports, have faced difficulties stemming from the peculiarities of their access to overseas markets. For many machinery and heavy equipment makers, the path to foreign markets was regularly as a materials supplier to Brazilian engineering firms executing construction projects abroad. The building and civil construction market, however, has experienced a sharp decline in business performance, both domestically and internationally, since the beginning of 2013, primarily due to the commodity cycle downturn. As a result of slowing demand, capital goods manufacturers have had to redirect their sales strategies to reach new buyers directly. This is a slow process, but the first signs of a successful adaptation have begun to manifest themselves in the applications for cover received by ABGF in the second half of 2016.

In parallel, many of the Brazilian civil engineering firms that led large export contracts have been absent from new cover demand as they are reviewing their compliance frameworks. They have implemented new corporate governance that will likely change their approach to new business, irrespective of whether it is abroad or domestic. For the most part, the companies are moving in the right direction of higher transparency and stronger compliance standards.

Even for the civil aircraft market – ABGF's other main source of business – changes abound. The last couple of years have been devoted to sales campaigns to renew the US regional fleets. Now that this phase has run its course, the Brazilian manufacturer will focus on perfecting and marketing its new generation aircraft. As with any complex product launch, the company has to maintain revenue sources to bridge the transition period. It is true that there are opportunities in the private jet and defence transport segments, as well as in new geographical markets, especially Asia, and demand for cover is expected to grow gradually in the next few years.

The crisis in Brazil has provided the Brazilian ECA with another opportunity. It has been partnering with the commercial banks in MLT financing. Their interest has come just in time to pick up the slack from the receding official banks. Most of them are foreign banks keen on supporting structured deals in compliance with ECAs best practices. Though the banks have shown some appetite for Latin American and African countries in MLT financing, there is some expectation that insurance can evolve into an unconditional guarantee for some competitive sectors. Such changes would be positive once the required legislative changes have opened the door to reinsurance and similar forms of risk sharing with other export credit agencies.

In conclusion, trade and export finance in Brazil have come upon some unexpected hurdles, but we see the system working and revamping its own policies and products in preparation for higher demand for export credit insurance facilities in the next couple of years. The outlook is positive and ABGF is a firm believer that the Latin American market will bounce back, with project and structured finance re-emerging as an opportunity. ■

# BECI: Business opportunities, challenges and change

**By Cowell Habana, general manager, BECI**

BECI has over 19 years as an export credit agency providing credit insurance (both export and domestic) to the Botswana business community. Although BECI has been in business for this long, it is still struggling with low penetration rates for the credit insurance product more especially on the export credit insurance. Appreciation and uptake of our services and products have remained constrained to little growth in terms of the Premiums and critical mass needed for profitability. With a population of just about 2.1 million, and given that unemployment and poverty levels are pretty high at 18% and 20% (according the World Bank's April 2016 report) respectively Botswana also presents a very small market for local business to tap into. Our research has shown that with a broad spread of risk (where a company has a large number of trade credit customers), credit insurance will be more attractive to the businesses.

Botswana, like the rest of Southern African countries, has also been grappling with power & water shortages, drought and low economic growth which have made doing business difficult. This has contributed to a number of covered buyers' insolvency (non-payment of an account and/or admission by the company that they are unable to settle a debt) directly impacting our operational costs. A number of businesses who cannot service their accounts grew by 25% from 2013 to 2015 increasing the claims costs while policy cancellations grew by 10% year on year from 2013.

The salvages in Botswana are below other ECAs average of 70%, mostly because all the companies will be near bankruptcy at the time claims are paid and the recovery/collection process starts. The legal collection process can also take long (up to three years) especially where a debtor enters an appearance to defend.


Cowell Habana

Despite these challenges the environment in Botswana has also presented opportunities to BECI for products like import/export financing, short term domestic trade financing, medium to long-term export credit insurance and investment insurance, and the need to set up a credit information services function to compete with the only credit bureau in the local market.

Two well established ECAs in the region have shown interest to assist train and equip our staff with the relevant skills. This will place BECI in a better position to fully exploit all opportunities and proactively manage all risks to the business.

Currently BECI is looking to review its business model to be able to take advantage of these opportunities. The review of the organisational structure and alignment of functions and roles is undergoing changes to improve efficiency benchmarking with other ECAs of the same size. BECI has also made a deliberate move to collaborate more with government agencies and parastatals working on economic diversification, export strategy, business development like Citizen Economic Development Agency, Local Enterprises Authority, Botswana Investment and Trade Centre etc. This relationships will put us at the forefront of advancing our interests and increasing our product awareness to a broader market nationwide. ■

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# PICC: Our three measures to survive and compete against a dominant player

**By Zhongzhu Chen, general manager of credit insurance and surety, PICC**

As one of the world's largest and fastest developing countries, China still heavily relies on the engine of exports in driving its economic growth. The Chinese government takes export credit insurance as a top priority (in fact the first and foremost in its most recent policy blueprint) to encourage and boost Chinese exports. Following this direction, together with the impetus to break the monopoly of its official ECA, China's Ministry of Finance decided in late 2012 to open its short term export credit insurance to commercial players. In January 2013, PICC became the first insurance company to get the license and mandated to expand outreach to SMEs and to work on a commercially viable basis.

Being Asia's largest non-life insurance company, PICC has a market share of more than 34% in the Chinese property and casualty insurance industry, in which credit insurance is a sub-category as defined in the Chinese Insurance Law. We are especially strong in corporate business, with more than 2.5 million corporate clients for which PICC provides various kinds of products. In addition, above 170,000 full time employees work in our 4,500 branches and sub-branches all over China. Many of them are not new to export credit insurance, as PICC used to be the first and the only insurance company to underwrite this business for 13 years before Sinosure became independent from us in 2001. All of the above advantages add up to become the growth soil of our export credit insurance: huge client basis and extensive sales and service network. PICC is present within one hour's journey of every Chinese exporter.

Zhongzhu Chen

While we are mobilising our full strength to satisfy the demands of our existing customers and to make our entrance into the market a significant one, the official ECA of China, Sinosure, is working very hard and aggressively to push up the penetration rate of export credit insurance, but not for a profit.

**China still heavily relies on the engine of exports in driving its economic growth. The Chinese government takes export credit insurance as a top measure (in fact the first and foremost in its most recent policy blueprint) to encourage and boost Chinese exports.**

Competing with such a fearless player in such a red-hot market as China, PICC has adopted three measures in order to compete and survive.

First, to compete professionally. There has always been an argument for playing BIG first instead of professionally. Yet as the first state owned financial enterprise to be publicly listed in an overseas stock exchange (HKEX) as early as in 2003, PICC puts underwriting profits as its highest priority and requires every business line to make money to answer to our shareholders. We do not want to sacrifice the interests of our treaty reinsurers either. If we need their long time trust and support, we have to adopt and adhere to the world best practices. The standards of the world's best commercial credit insurance companies are the ones we work by.

Second, to train our own staff and make our own underwriting decisions. Unlike other players that followed us to get their licenses, PICC's top management have decided from the very beginning to build up a specialised team and nurture our own staffs to make our own underwriting decisions. Its Department of Credit Insurance & Surety enjoys the same status as Motor Vehicle Insurance Department (the latter has an annual premium of more than €30 billion), reports directly to PICC's top management and hires the most employees at our headquarters. We are active in ICISA and applied to return to Berne Union as soon as we became qualified. We do our own policy and buyer underwriting decisions to make sure that we satisfy the demands of our own customers.

Last, but most importantly, to make full use of our advantages. As the requirement to get the export license has long been nullified, every business on the Chinese soil could be our potential client. Our competitors are present mainly in the big exporting cities and cannot afford to build their own sales and service force extensively. With our organisational competitive edge, PICC moved very fast and soon beat off other players in small and medium cities in the western and mid-western provinces where the exporters long for localised services in connection with other kinds of non-life insurance products.

**On a playing field that is not yet levelled out and that is dominated by a giant official agency, we have managed to survive, compete and make inroads. Our business has grown significantly and steadily, earned profits for the past three years.**

On a playing field that is not yet levelled out and that is dominated by a giant official agency, we have managed to survive, compete and make inroads. Our business has grown significantly and steadily, earned profits for the past three years. About 90% of our 16,000 clients are small and medium exporters, making the product more available to SMEs in more remote areas. We admit that we are still at the inception and there is a long way to go. The most important thing is to live up to our original high ideals yet respond nimbly to changing opportunities. ■

**There has always been an argument for playing BIG first instead of professionally. Yet as the first state owned financial enterprise to be publicly listed in an overseas stock exchange (HKEX) as early as in 2003, PICC puts underwriting profits as its highest priority and requires every business line to make money to answer for the shareholders.**

# Changing region, changing business

**By Karim Nasrallah, general manager, Lebanese Credit Insurer (LCI)**

Business is changing as rapidly as the MENA region is transforming. The evolution of risk in the MENA region, to a more risk-averse, diligent approach, is due to the various events that have unfolded regionally and globally. Take the political unrest that has rippled through numerous countries and the ongoing turmoil in Yemen, Syria, Iraq, Turkey, Libya and Egypt, which have together, created a climate of uncertainty. The sharp decreases in oil prices too, have played a major role in impacting various national economies. In addition, although the full effect of the sanctions being lifted on Iran after nearly 40 years have not been felt, some countries and businesses have been affected – both positively and negatively.

With headlines coming out of the region being made on a daily basis, some countries are seemingly more affected that others in these times. Take for example Saudi Arabia, an oil-rich country which took a hit when its oil production and prices plummeted. In addition, the construction sector has been greatly impacted in Saudi Arabia, where it is facing serious delays in payments and default of payments from some companies. The Kingdom is undergoing a rigorous plan to diversify its investments into other sectors, to shift the heavy reliance on oil.


Karim Nasrallah

The United Arab Emirates on the other hand has seen various changes in its trade sector, which has been significantly affected, such as in the food sector. This is due to the evolution of the geopolitical situation with Iran and currency devaluation in some African countries, which were main importers of food from the UAE.

Another market that has been impacted is Egypt, known as a 'risky export market'. This is due to the significant devaluation of the

**Trade credit insurers in the MENA region have had to adapt to very specific adverse market conditions, and trade credit insurance, which protects a company's biggest asset, trade receivables, continues to transform as a result of the repercussions of regional and global developments.**

local currency, the Egyptian pound, as well as the new regulations and controlling measures taken by the Central Bank of Egypt, which have resulted in slowdown of imports of different types of goods.

Other countries too, have felt slight economic shocks, and companies are altering their business models and taking preventive measures as they have become more risk averse.

Trade credit insurers in the MENA region have had to adapt to very specific adverse market conditions, and trade credit insurance, which protects a company's biggest asset, trade receivables, continues to transform as a result of the repercussions of regional and global developments. Despite there being a spike in the demand for trade credit insurance policies after the Arab Spring developments, numerous factors in trade credit insurance have changed, such as the approach towards underwriting, how risk is viewed, and how insurers cover different sectors.

Some notable steps that few trade credit insurance companies operating in the MENA region are taking in these challenging times include:

Focusing on more 'stable' markets such as Oman, Kuwait and Egypt, to develop business prospects and reach. Despite the difficult economic situation being experienced in these countries, the credit default remains positive and stable. For example, despite the fact that imports to Egypt are deemed risky due to the currency fluctuation and foreign exchange restrictions, as well as difficulties in obtaining foreign currencies, the domestic policies that are issued in the Egyptian pound are showing favorable performance.

Companies in trade credit insurance are also being more vigilant when it comes to KYC or 'know your customer'. Prospective clients are now subject to a complete analysis, including: Prospect Financial Performance, Prospect Credit Management and previous performance, a review of the line of business they operate in, type and quality of customers etc.

**Despite there being a spike in the demand for trade credit insurance policies after the Arab Spring developments, numerous factors in trade credit insurance have changed, such as the approach towards underwriting, how risk is viewed, and how insurers cover different sectors.**

In addition, in order for companies to grant coverage for each customer, this decision is significantly influenced by macro analysis factors such as the country, sector and subsector performance in which they operate.

In summary, the challenges that regional and global changes have brought on to businesses will result in a more risk averse climate, with companies being more attentive to 'red flags' before venturing into business with clients or countries. ■

**Companies in trade credit insurance are also being more vigilant when it comes to KYC or 'know your customer'.**

# Transfer of the state guarantees from Coface to Bpifrance

**By Maëlia Dufour, sous-directeur, direction des garanties publiques, Coface**

In July 2015, the French government decided to transfer Coface State guarantees' activities to Bpifrance; the decision was approved in December 2015 by the French parliament. This is the culmination of a process of reflection and analysis that began with the creation of the public bank Bpifrance, to streamline the State financial support for French exports around this new stakeholder, which placed internationalisation at the heart of its strategic objectives. It's the end of a chapter, but, most important, it is a story that will continue.

## One-stop-shop approach

The management of State guarantees will be ceded to Bpifrance Assurance Export, a new subsidiary of the Bpifrance group created specifically for that purpose. All the teams currently in charge of managing the State guarantees at Coface will be transferred to Bpifrance Assurance Export.

**In July 2015, the French government decided to transfer Coface State guarantees' activities to Bpifrance; the decision was approved in December 2015 by the French parliament.**

The combined expertise of Coface and the Bpifrance group will provide a full range services for export activities through a one-stop-shop approach to simplify the offer for our customers and promote more public support tools with Bpifrance's local network and a continuum of financing solutions, from companies' early development phase to maturity, even for small amounts.

This transfer aims to further boost the SME embrace of globalisation, and also to better meet the larger companies' requirements.

Maëlia Dufour

## Direct guarantee in the name of the French State

Currently the guarantees are granted by Coface on behalf of the French State.

French law applies for the transfer of all State guarantees' subscribed policies and will simplify the current guarantee framework with a direct guarantee. Bpifrance Assurance Export therefore will manage the entire portfolio, not only on behalf of the French State but also in its name. This direct guarantee from the French State was a longstanding request from policyholders, especially for larger transactions in which each basis point saved on the pricing of the financing determines the competitiveness of the French offer.

The transfer of the activities, portfolio and teams is scheduled to take place no later than the 31st December, 2016. Until then, a broad cooperation between Coface and Bpifrance ensures a seamless continuity of service to all insured parties and export companies and the continuance of good relationship with Coface partners worldwide.

Insurers 'rights and obligations will not be changed. The continuity of contracts will be maintained in favour of all policyholders and other beneficiaries.

All players involved are aware that this transfer is a crucial issue to succeed in developing French exports for all kinds of players from small to large companies. ■

EXPERT ANALYSIS

# NEXI's transformation to a stock company and its future

**By Kazuhiko Bando, chairman and CEO, NEXI**

During the 2015 ordinary session of the National Diet of Japan, the Act for Partial Revision of the Trade and Investment Insurance Act has been enacted. Under the Act, the Japanese government is to take necessary measures to change Nippon Export and Investment Insurance (NEXI) into a special stock company fully funded by the government, abolish the Trade Reinsurance Special Account of the Government, and have NEXI succeed to the assets and liabilities of the Account after NEXI changes into a special stock company, to be implemented in April 2017.

The revised act is to change NEXI into a stock company in order to enhance its governance, and also to make the government hold all the issued shares of the organisation, considering the characteristics of trade insurance which will cover risks not covered by private insurers.

The revised act is to abolish the Trade Reinsurance Special Account of the Government as a reinsurer for NEXI, and to have NEXI succeed to the assets and liabilities of the account with the view to centralising accounts related to trade insurance, thereby streamlining the government's administrative and fiscal system.


Kazuhiko Bando

In addition, aiming to ensure the payment of insurance claims even in case of an emergency, e.g., frequent occurrences of insured events, the revised act stipulates that the government shall take necessary financial measures when it is deemed difficult for NEXI to procure funds necessary for conducting business operations.

The revised act requires the government to stipulate the criteria for insurance coverage for NEXI, which is an organisation

**In May 2016, Prime Minister Abe delivered an initiative titled Expanded Partnership for Quality Infrastructure. Through the initiative, Japan will encourage exports of its high-quality infrastructure and construct win-win relationships that contribute both to domestic economic growth and to economic development of partner countries.**

to implement the national policies including the fields to be focused on, in order to reflect the government policies in the coverage of trade insurance. It also stipulates that the government may deliver opinions to NEXI concerning certain significant projects.

The new NEXI will continue to promote international transactions by Japanese companies including infrastructure export by improving its managerial flexibility, efficiency and agility while maintaining unity with the government in terms of trade policy.

In May 2015, Prime Minister Shinzo Abe announced the Partnership for Quality Infrastructure to accommodate huge demand for infrastructure in Asia by providing high-quality investments. It was announced that Japan, to strengthen its collaborative relationship with Asian Development Bank (ADB), will provide approximately $110 billion (about a 30% increase) for "quality infrastructure investment" in Asia over the next five years. This initiative is to play a catalytic role in further mobilising financial resources and know-how from the private sector across the globe to Asia, a region full of potential, in such a way that promotes infrastructure investment that the region needs, both in terms of quantity and quality.

**To survive in the international competition in the ongoing economic globalisation, public and private sectors must continue to work together.**

Also in May 2016, Prime Minister Abe delivered an initiative titled Expanded Partnership for Quality Infrastructure. Through the initiative, Japan will encourage exports of its high-quality infrastructure and construct win-win relationships that contribute both to domestic economic growth and to economic development of partner countries. To this end, Japan will aim to provide, among all, financing of approximately $200 billion in the next five years to be allocated to infrastructure projects across the world, including those for natural resources, energy, etc. In addition, Japan will further improve related measures for promotion of quality infrastructure investment.

**Japan, to strengthen its collaborative relationship with Asian Development Bank, will provide approximately $110 billion (about a 30% increase) for "quality infrastructure investment" in Asia over the next five years.**

Following the announcement, NEXI started various capability enhancement measures including creation of insurance for sub-sovereign transactions. NEXI also made efforts to help Japanese companies to increase competitiveness in the overseas market by actively supporting their infrastructure projects including power and telecommunications and agriculture.

To survive in the international competition in the ongoing economic globalisation, public and private sectors must continue to work together. NEXI will continue to provide quality insurance services that meet diverse business needs. ■

**The new NEXI will continue to promote international transactions by Japanese companies including infrastructure export by improving its managerial flexibility, efficiency and agility while maintaining unity with the government in terms of trade policy.**

# Exploring new opportunities in the energy sector: Key considerations to underwriting successful projects

By Benjamin Mugisha, senior underwriter, Africa Trade Insurance Agency (ATI)

The energy sector represents a bold new frontier for export credit agencies (ECAs). Increased involvement in this sector makes good business sense. With an estimated 1.1 billion people globally living without access to electricity and another 2.9 billion relying on dangerous and polluting biomass for their daily needs, – the social and environmental imperatives are quite high.

This article is written from the perspective of the African Trade Insurance Agency's (ATI) areas of operation and experience. The intent is to focus on areas that we feel must be addressed in underwriting energy sector transactions.

ATI is a multilateral institution operating in and based in Africa. Each of the countries in which we operate has a unique investment environment and a few common denominators:

- Many of our countries are under developed economies;
- The regulatory framework is often poorly developed or undergoing significant change; and
- Often, payment obligations are being insured but additional political risks may be included.


Benjamin Mugisha

Underwriting energy projects is not an exact science. Several considerations are specific not only to the nature of the transaction but also to the country in which the project is being undertaken and the parties to the project – especially the client(s). The underlying transaction is often based on a key contract, e.g. a power purchase agreement. The clauses of this contract need to be critically assessed when underwriting the transaction.

Based on our experience, there are three areas that require scrutiny:

### 1. Nature of the transaction

Energy transactions are often long-term infrastructure-related projects structured for project financing. This is an important consideration because recourse is often limited to repayments from a single offtaker. The ability of this offtaker to meet their obligations is critical. In our countries there is

**Many African governments try to avoid back-stopping infrastructure projects undertaken by their agencies. In the absence of the preferred government guarantee, investors may instead be given a diluted form of sovereign support. It is important to assess not only the tangibility of this support but also its legality.**

a large variance in the track record and reputation of each off-taker. Partial solutions can be structured e.g., escrow accounts, liquidity guarantees or reserve accounts. We have found it prudent to cover default on an arbitral award rather than straight non-payment.

**Energy specialist underwriting is not a science. No two projects will be the same and always expect the unexpected!**

## 2. The client

Typically the transactional client will either be a lender or equity investor. In some cases, both will seek insurance. It is important to consider the insured's due diligence to key issues likely to delay or deter the project. Examples include:

- Carrying out pre-feasibility and feasibility assessments that address all concerns such as the social, environmental and technical aspects. For environmental aspects, more often than not, complying with national requirements is not enough. It may be necessary to benchmark against global standards;
- Sound contracts for implementation and operation of the plant; and
- Negotiating a bankable agreement with the off-taker. Many African governments try to avoid back-stopping infrastructure projects undertaken by their agencies. In the absence of the preferred government guarantee, investors may instead be given a diluted form of sovereign support. It is important to assess not only the tangibility of this support but also its legality ; and

## 3. Other players

Other parties can also have an important role in underwriting considerations. The existence of donor funding, multilateral agencies, ECAs and development finance institutions, all contribute to both appetite and the pricing of a transaction.

## Summary

I would like to leave you with some specific areas to consider when underwriting energy transactions namely:

i) Project structure;
ii) Financial strength and track record of the off-taker or buyer;
iii) Contractual agreements between the insurer and risk party, with specific emphasis on standardization, tariffs, definition of force majeure, immunity, governing law, dispute resolution including arbitration, termination and termination payments, assignment, off-taker/buyer payment support, transmission/interconnection risks. Without experience, developers and equity investors could overlook some of these aspects so the underwriter will need to double check their assumptions;
iv) Credit enhancements and risk mitigation instruments including guarantees, swaps and liquidity facilities;
v) Possible success and failure factors;
vi) Environment and social aspects; and
vii) The rights of the insured and whether these can be subrogated to the underwriter;

## Conclusion

We end as we started. Energy specialist underwriting is not a science. No two projects will be the same and always expect the unexpected! ■

**Underwriting energy projects is not an exact science. Several considerations are specific not only to the nature of the transaction but also to the country in which the project is being undertaken and the parties to the project – especially the client(s).**

# Walking a tight rope

**By Geetha Muralidhar, chairman and managing director, Export Credit Guarantee Corporation of India**

## Introduction

Export credit agencies offering only 'pure covers' i.e. only credit insurance, have been instrumental in promoting international trade since the dawn of the century. Credit insurance is an insurance activity with a unique mitigation capability when managed with a clear credit underwriting policy with as many parameters like maximum liability, percentage of cover, etc., to cap the losses at any point in time. Another aspect of the credit insurance's ability to mitigate the risk is through some consideration of the probability of default and underwriting options which will address the stress situation. Due to its underwriting capability and short term maturity, any relevant adverse change can be managed before the end of a one year horizon with even the reduction of exposure.

The loss ratio's graph for an enterprise would get amplified at the crest without credit insurance mitigation arrangement. Credit insurance demonstrates the ability to go through the economic cycle with individual reviews of the buyers monitored by geography and industry. The exposure could also be already restricted on a buyer while taking into account the sensitivities of the sector. Thus credit insurance has a unique capability to smoothen the risks through the economic cycles and thereby reduce its adverse impact on a worst case scenario.

## Credit risk

As regards credit exposures, there is a clear difference between bank credit and credit insurance. Bank loans are given to an entity on a 'going concern' basis particularly in developing economies and the facility would have to be invariably renewed, barring some exceptional situations. Credit insurance is also renewable, but also cancellable by either party. Should the debtor undergo changes, say, declining creditworthiness, bank credit remains unchanged at 100% debt. Whereas in insurance, only amounts committed with

Geetha Muralidhar

invoices sent to an affected debtor is stuck and appropriate action to reprice, contain, reduce or even deny a cover for future is possible. Hence the banking model cannot be adopted straightaway to credit insurance, given the above clarity on the specific nature of insurance.

## Solvency

Guidelines on bank credit risk under Basel II are specifically applicable to business risk just as the Underwriting Risk Model is for the credit insurance line of business. Credit insurance is widely used by financial institutions to mitigate their risks wherein the risk gets transferred to the insurance company. In the Insurance business, Solvency II directives define a credit risk (in respect of third party debtors) of an insurance company. Solvency II considers only a 12 month timescale. This means that the calculated Solvency Capital Requirement (SCR) must be sufficient to guarantee the solvency for the insurer over this period. This also dictates that the SCR calculation must be in consonance with the Enterprise Risk Management (ERM). If the business model and/ or the behaviour of the assumed risks represent a longer term view, the capital calculation should also be accordingly addressed.

Credit risk as accepted in Solvency II is associated with three sub categories of risks :

a) Premium and Reserve risk – a simple model based on Value at Risk [VaR] over the volume of premiums and reserves.
b) Lapse risk – is the risk that a substantial volume of policies would be cancelled or not and its effect on solvency.
c) Catastrophic risk – risk of simultaneous large claims and the risk of recession.

Specific parameters of credit insurance and their influence over a one year horizon risk on capital computation would be that policies include insurance features thereby limiting the risk by way of a) maximum liability, b) consideration on the basis of a portfolio and c) the backing of reinsurance. However, in the current global situation, post 2007, adequate ERM is warranted while ensuring solvency over a longer time scale, say at least three to five years.

Each insurer can, however, use a model that is best suited for its purpose with the condition that it obtains authorisation from the regulator, if the latter permits such consideration.

### Credit risk model

The important features in a credit risk model will be factors like the ability to pay, and the default probability of a buyer. The model could take into account a number of factors: industry, country, etc. Each buyer is characterised by a default probability and with the given default probabilities the model could use the fact that a company will be defaulting if it's ability to pay is lower than a certain threshold.

In another approach, in addition to default / non default approach, factors like liquidity, dilution of capital, size of company, legal structure, etc., can also be built in.

After obtaining the buyer rating and fixing the exposure limit, the buyer level, exporter level, group level, etc., exposures can be aggregated. Analysing the risks individually and allowing subsequent aggregation is a genuine Insurance method.

Sometimes assumptions result in underestimating the extreme events. In order to compensate for this, the intensity of certain critical connections between factors can be deliberately worsened in the model. This approach, NORTA [normal to anything], can be applied on the whole portfolio. The outcome will complement the benchmark approach in credit insurance and enable adjustment of tail distribution.

### Accounting – reserves and provisions

Credit insurance also follows accounting on accrual basis with a 'going concern' concept i.e., to maintain accounting records with the assumption that it would continue to operate indefinitely. Reserves are estimates an insurer needs to pay future contract obligations. Reserves make up a significant portion of an insurer's liabilities.

Estimates of outstanding claims can be provided for on a case-by-case basis and using statistical methods at the portfolio level.

For the purpose of clarity, it may be understood that reserves strengthen the financial position of the insurer to meet future unknown losses and liabilities; whereas provisions are made to meet known losses and liabilities with amounts not being certain. Free reserves are created when enough profits are made whereas provisions are created even if there is a loss in business.

**The objective is to promote exports and not maximise profits. The stability of support by an ECA is paramount particularly in an economic downturn.**

Reserving (Technical Provisions) is of two categories:

a) Premium based – unearned premium reserve (UPR), unexpired Risk Reserve (URR) which includes Premium Deficiency Reserve (PDR).
b) Loss (claim) based – Incurred But Not Reported (IBNR), Incurred But Not Enough Reported [IBNER], Catastrophic (CAT) reserves, etc. Reserves are required to cover unexpired risks and meet unknown losses.

Apart from the capacity derived from the above reserves strength, the extent of exposures that may be retained also needs a review. The relevant retention policy is always a function of the financial robustness of an insurer. In this regard, the most important factors are solvency, regulations, underwriting capacity, financial strength, corporate willingness to take risks, reinsurance support, portfolio composition and large risk and CAT protection. As a matter of prudence, Exposure retention is almost always linked to the net worth of an insurer.

Thus export credit insurance is a capital intensive business with a demand for single high value risks which are backed by large orders. A boom will warrant more capital as the jump in business would be more pronounced than in other lines of insurance.

## Pricing and reserves – ECGC's experience

ECGC, perhaps the only ECA subject to insurance regulations, has a regulatory balance sheet based solvency ratio of 9.79 and an economic capital based balance sheet solvency ratio of 2.3 which depicts the financial robustness at present. The major challenge is to address the need for a decent return on capital, while pursuing the objective of export promotion in keeping with the vision and mission with which ECGC was set up. So pricing is a tight rope walk with investment income being the saviour.

Global data availability of congruent products is a challenge while pricing new products. Products of different ECAs are directly not comparable. So, even proxy data is not available. Historical data of existing products is used for pricing new products. However, the relevance of historic data in the changing dynamics of global business cycle needs to be considered while pricing new products. Demanding customers with specific needs seek a customised product and pressurised insurers succumb by cutting rates and losing spread by tossing out established pricing techniques.

ECGC has an 'experience rating mechanism' in place for covers issued to exporters and banks. The effect of large claims is reflected at the renewal time with the withdrawal of NCB and/or loading of premium rates and reduction in the percentage of cover. ECGC does not factor in reinsurance arrangements into pricing of any product.

A reserve for unexpired risk requires to be created to the extent of premium income attributable and allocated to succeeding accounting periods which is 50% of net premium income.

ECGC's specific reserving methods...

a) outstanding claims reserve / claim estimate reserves are accounted on the basis of accepted and acknowledged claims which the insurer expects to settle.
b) Unexpired risk reserve calculated at 50% of the net written premium of the financial year (as per the regulator).
c) Premium deficiency reserve (PDR) ...if the result of 'unexpired risk reserve' less the sum of (expected claims cost plus claims handling expenses is positive) then a PDR is not required or else a PDR would need to be created for the deficit. Actuary has to certify the expected claim costs.
d) IBNR claims reserves. A point estimate I.e., a deterministic approach is being used to calculate IBNR. Normally 85% to 90% of claims incurred are paid within two years. Long tail claims are expected to fully run off in eight years (repudiation, representation, litigation cycles, etc). Pure IBNR is calculated on a net of reinsurance basis.

## Balancing act

Constraints faced by ECGC over a period of time, owing to regulations and compliance in carrying out its mandate, have been causing concern in the Indian context. They exist in the areas of pricing, product profile, prudential exposures, etc.

Price moderations in response to market demand/slump or decrease in exports cannot be effected in a timely manner without establishing viability through actuarial assessment. Similarly, in quick response to market demands, a new product or modifications to existing products cannot be introduced until actuarial certification is obtained. As in motor or marine insurance, each risk needs to be measured through life cycles, namely: performance, claims, recovery, etc. This kind of analysis may not be directly relevant to export credit insurance offered with a promotion objective of an ECA.

An overall surplus is not sufficient and no product can subsidise another as per regulations while ECAs operate on a long term financial sustainability as per budget accounting method and not on an annual basis surplus as per regular insurance accounting. The objective is to promote exports and not maximise profits. The stability of support by an ECA is paramount particularly in an economic downturn. Most of the credit insurers have mono line businesses and concentration risk is another challenge with country, sector, buyer risks being highly volatile.

ECGC has to worry about concentration risks which results in lost export opportunities. Support for bank lending to exporters is also not wholesome owing to the prudential risk monitoring which affects the credit flows to the export industry. ECGC is indeed walking a tight rope since it has been subject to insurance regulations while balancing its role between the mandate of export promotion and the compliance of insurance regulations. In order to empower the organisation for an enhanced role, it is time to review the present status and reinforce its role in consonance with its goals having already imbibed the discipline of regulations. ■

EXPERT ANALYSIS

# Financing gaps, mobilisation and the importance of enhanced cooperation between development financiers and Berne Union members

**By Paul Mudde, Sustainable Finance & Insurance**

## Introduction

The needs for infrastructure in developing countries are enormous. There is a huge gap between these needs and the financing that is available from government's own resources and funds from Development Finance Institutions (DFIs)[1]. According to the World Bank[2] the lack of infrastructure comes at enormous economic and social cost. Over 1.3 billion people – almost 20 percent of the world's population – still have no access to electricity. About 768 million people worldwide lack access to clean water; and 2.5 billion do not have adequate sanitation; 2.8 billion people still cook their food with solid fuels (such as wood); and one billion people live more than two kilometres from an all-weather road. This strong unmet demand for infrastructure investment in developing countries is estimated at above $1 trillion a year. In addition – and further increasing the financing gap – countries face the enormous task to attract huge amounts of finance to combat climate change[3] and to achieve the UN Sustainable Development Goals (SDGs).[4]

Involvement of non-development financiers[5] such as commercial banks, official Export Credit Agencies (ECAs)[6], Private Insurers (PRIs) and capital market investors is therefore crucial. Through closer and improved cooperation more financing could become available to bridge the current financing gap. This explains why the mobilisation of non-developmental sources of capital is of great importance to developing countries and their strategic development partners among which the DFIs. It implies also a redesign of the DFI strategies.

Paul Mudde

***Report of World Economic Forum' Building on the Monterrey Consensus: The Untapped Potential of Development Finance Institutions to Catalyse Private Investment" (2006).***

*"There remains a critical role for MDBs to make direct loans and grants, and provide policy advice. But given the potential availability of private capital in most developing countries as well as the sheer scale of investment needed to fulfill the MDG targets and infrastructure requirements in them, the overwhelming majority of the more than 200 expert participants in this project took the view that the weight of DFI activities should shift over time from direct lending to facilitating the mobilisation of resources from the world's large private savings pools – international and domestic – for development oriented investments through:*

1. *wider use of risk mitigation instruments to alleviate part of the risk faced by investors; and*
2. *stronger direct support for capacity building to strengthen the enabling environment for investment"*

A pure lending focus is no longer sufficient. DFIs have to enhance their role as catalyst for development. This means among others that more resources have to be allocated to project development to increase the number

**A pure lending focus is no longer sufficient. DFIs have to enhance their role as catalyst for development.**

of bankable projects. For the lack of bankable projects is currently one of the largest bottlenecks in financing infrastructure. An interesting initiative of the DFI community is the International Infrastructure Support System (IISS), which is a public project management tool enabling government and public sector agencies to improve their project preparation activities.[7] Furthermore DFIs have to develop strategies with concrete targets, the right incentives and products (e.g. guarantees) to mobilise non-developmental sources of capital. There are, however, some serious challenges regarding the current mobilisation agenda of the DFI community.

## Measurement of mobilisation: What gets measured, gets done

The problem with mobilisation is that each DFI has its own definition of mobilisation and system to measure mobilisation impact. For many DFIs it is a common practice to attribute the entire (co)financing of a project to their financial intervention, which leads to unrealistically high mobilisation figures and double counting in case two or more DFIs are involved in a project, which is also partially cofinanced by commercial banks. The commercial bank financing is accounted twice as mobilised capital by two different DFIs. Furthermore DFIs do not make a distinction between the mobilisation of other developmental sources of capital (e.g. funds from other multilateral or bilateral donors) and funds from non-developmental sources (commercial banks, capital markets, ECAs private insurers), which again lead to a form of double counting. Some DFIs include in their mobilisation figures cofinancing provided by third parties even when the DFI has not played an active role in arranging the commercial (co)financing. Other DFIs require a true arranger role (with payment of an arranger fee) to distinguish mobilisation from cofinancing. Mobilisation is often misunderstood and figures reported are not comparable and do not always relate to an active catalyst (arranger or risk transfer) role of a DFI. An example is a recent press release of leading Multilateral Development Banks (MDBs) about their the joint climate finance report, which states that "climate finance totaling $81 billion was mobilised for projects funded by the world's six largest multilateral development banks (MDBs) in 2015. This included $25 billion of MDBs' direct climate finance, combined with a further $56 billion from other investors"[8]. The $56 billion concerns cofinancing in general of which the vast majority concerns parallel cofinancing, in which the MDB was not actively involved. And furthermore it is likely that a large share of the $56 billion concerns financing supported by ECAs.

***World Bank Financing for development post 2015 (October 2013).***

*"Faced with limited direct lending capacity going forward, and the fiscal constraints of many of their major shareholders, it is increasingly important for MDBs to fully utilise their catalytic role and leveraging potential to mobilise additional financing from diverse sources."*

These and other imperfections are recognised by the OECD DAC, which explains why currently discussions take place to develop a common system for the measurement of mobilisation of private capital. Thus far the OECD DAC has conducted a few pilot surveys with a joint measurement methodology for a limited number of DFI financial instruments (among which for development guarantees and A/B loans), but the suggested methodologies are unfortunately not realistic. The focus of the OECD DAC is to measure the mobilisation by DFIs, which are defined as multilateral and bilateral organisations with an explicit developmental mandate. A few ECAs / public investment insurers with a dual mandate (i.e. promotion of exports/ investments and development) are part of the OECD DAC survey's (e.g. JBIC and OPIC), but most ECAs are excluded from this exercise. The OECD DAC approach ignores that public non-developmental sources of capital (among which ECA insurance capacity) can be mobilised for the focus is on private capital. It discourages cooperation between DFIs and ECAs, which is unfortunate because ECAs are vital in financing infrastructure in developing countries.

The OECD DAC pilot methodology to measure mobilisation through development guarantees suggests that the entire principal loan amount can be reported as mobilised capital irrespective the type of cover (partial risk or partial credit guarantees) and the percentage of cover that is provided. From a technical point of view it would be better to include in the mobilisation figure only the uncovered part of the loan (e.g. 10%)[9]. By reporting the full loan amount the system ignores that the DFI itself has to allocate risk capital to provide the guarantee and the fact that the DFI already reports this guarantee exposure as its contribution to development. In a sense the current OECD DAC approach for guarantees could lead to a new form of double counting. Moreover this methodology is a disincentive for a DFI to seek reinsurance for its guarantee exposure, for the full loan amount is already captured in the OECD measurement system.

It is noteworthy that the OECD has not (yet?) developed methodologies to measure mobilisation through insurance of DFI loan exposure or reinsurance of DFI guarantee exposure, while both risk transfer techniques are very effective tools to mobilise capital from ECAs and PRIs. Only a few DFIs make use of these risk transfer techniques[10].

There are many other outstanding issues regarding DFI mobilisation practices and the OECD efforts for a common methodology for mobilisation calculations, which is quite concerning given the enormous challenges in bridging the financing gap. Successful mobilisation strategies require an adequate and realistic measurement system. Without such a system mobilisation will be suboptimal or an artificial exercise, which is obviously not in the interest of developing countries.

### Mobilisation of private capital is much more than only PPP

There is tendency within the aid community to narrow the discussions on the mobilisation of private capital to the development of public private partnerships (PPPs), in particular through project finance. The latter concerns projects that have the potential to generate sufficient income to repay commercial debt financing and pay dividend to equity investors. The too narrow approach ignores four important facts, namely that (1) most infrastructure assets in developing countries are currently owned, managed and financed by the public sector[11] (2) many infrastructure projects cannot be financed on a project finance basis, because the projects do not generate sufficient cash flow and (3) many, in particular high-risk, countries lack an adequate PPP framework and/or attractive investment climate and last but not least: (4) private capital can not only be mobilised for private sector sponsored PPP projects, but also for typical public sector projects, whereby the government (sovereign) or a sub-sovereign entity (e.g. municipality) or state owned enterprise (SOE) acts as borrower or guarantor. This is for example relevant for most transport, electricity distribution, climate adaptation and water projects. Most roads, railways, regional airports, harbours, drinking water & sanitation projects are and will likely remain typical public sector projects in many developing countries[12].

In India, which is the most advanced in private sector participation in infrastructure, 64% of the country's infrastructure is financed and managed by the public sector. In most other developing countries, the share of public sector infrastructure is likely substantially higher. PPP can contribute to infrastructure, but is clearly not the panacea. DFIs' infrastructure – and mobilisation strategies should therefore also focus on public sector infrastructure.

The opportunities for the mobilisation of capital for public sector projects are substantial. Many governments in developing countries – in particular middle-income countries – have good or reasonable access to the private market and can obtain support from ECAs and PRIs for MLT financing for public sector projects. This concerns in particular countries that are rated in OECD ECA risk categories 2 to 4, but opportunities also exist in countries with a higher risk profile. The impressive overlap of exposures of for example IBRD/IDA[13] and Berne Union members on many countries show there are huge opportunities for cooperation and alignment of operations (see table I). These opportunities should be explored and utilised to mobilise more financing for development and to improve aid efficiency and aid effectiveness.

**In order to avoid distortion of competition between public sources of finance caused by pricing differences and to strengthen the complementary role of DFIs, DFIs should consider applying the OECD minimum premium system for the pricing of their MLT cross-border trade related lending and guarantee operations.**

Official ECAs and PRIs are an important source of capital for MLT financing of infrastructure in and trade with developing countries. The total MLT exposure of all ECAs + PRIs was in 2014 approximately $936 billion[14], which is more than two times the $422 billion exposure of all leading MDBs (see table II). The mandates of ECAs and PRIs are obviously different than those of MDBs, but they have an important developmental impact in facilitating imports and investments in developing countries. This is not measured nor communicated by the ECA community, which partially explains that their developmental role is not adequately recognised within the aid community.

Another reason why the ECA and aid communities do not know each other very well is that aid and official export credit issues and regulations are discussed in different international meetings with representatives from different ministries of governments / government agencies. There is hardly any strategic interaction between aid and export credit representatives. Furthermore, discussions in the OECD DAC focus primarily on measuring and improving social and environmental impact of development activities, which are the People P and Planet P dimensions of sustainable development. The Profit P dimension of sustainable development – how scarce development capital can be used in the most effective and efficient way and crowding out

**Table I : Top 6 IBRD/ IDA borrowing countries, OECD ECA rating and BU MLT exposure (in billion U$)**

| *Country* | *OECD ECA Country risk rating (July 2016)* | *IBRD / IDA outstanding loans (July 2016)* | *BU MLT exposure at year end 2015 (*)* |
|---|---|---|---|
| Brazil | 4 | 16.1 | 42.6 |
| Mexico | 3 | 14.7 | 24.9 |
| Indonesia | 3 | 16.8 | 40.1 |
| China | 2 | 16.5 | 32 |
| India | 3 | 37.4 | 23.7 |
| Turkey | 4 | 11.3 | 39 |

Source: World Bank and Berne Union.

(*) The figures concern MLT export credit and investment insurance exposure of all Berne Union members.

**Table II: The global portfolios of leading MDBs and MLT exposure of BU members (2014 in million $)**

| *MDB* | *Exposure outstanding* | *Berne Union members* | *Exposure outstanding* |
|---|---|---|---|
| IBRD/ IDA | 153,691 | MLT export credits | 701,657 |
| IFC | 36,622 | MLT investment insurance (3) | 234,580 |
| ADB | 58,492 | | |
| IaDB | 74,836 | | |
| AfDB | 18,906 | | |
| EBRD | 29,783 | | |
| EIB (only outside EU) (2) | 49,490 | | |
| **Total** | **421,820** | **Total** | **936,237** |
| BU exposure in % of MDB exposure | 222% | | |
| MDB exposure in % of BU exposure | 45% | | |

Source: Berne Union, MDB annual reports and calculations by Sustainable Finance & Insurance

Please note:

(1) MDB exposure concerns: loans outstanding, equity investments and guarantees outstanding

(2) EIB 's portfolio regarding business outside the EU is approximately 10% of its total business portfolio

(3) The MLT investment insurance exposure of Berne Union members includes MLT insurance exposure of four multilateral insurers, i.e. MIGA (in 2014: approx. $12.4 billion), ICIEC (in 2013: approx. $898 million) and ATI (in 2014: estimated at approx. $800 million) and Dhaman (in 2014: estimated at approx. $800 million).

of market based finance be avoided (i.e. the complementary role of development finance) – is in fact not or much less discussed within the aid community. Aid efficiency and aid effectiveness are important topics in the OECD DAC, but the focus is on donor coordination and alignment of operations within the aid community. Alignment of DFI operations with non-developmental sources of capital is unfortunately not high on the international aid agenda.

The two worlds of development finance and ECA finance seem to operate in splendid isolation and opportunities for enhanced cooperation are not explored and used to their fullest potential.[15] An example of this are recent OECD G20 documents about financing infrastructure[16] in which nothing is mentioned about the important role of ECAs. The focus in these G20 reports is on the role of DFIs, ODA and the need to involve capital market investors in infrastructure. ECAs have to reach out towards important international bodies such as the G20, the UN and the aid community at large. Cooperation starts with sharing of information and knowledge.

### From DFI loans to DFI guarantees

Although it is generally recognised that guarantees are the best instrument to directly mobilise private capital and many multilateral DFIs have a guarantee program (e.g. partial risk and partial credit guarantees), guarantees are hardly used. Currently less then 1,5% of the total business of leading MDBs concerns MLT guarantees. For bilateral DFIs this is much lower. The main business of most DFIs is to provide MLT loans to governments and projects in developing countries. The problem with loans is that they do not or hardly directly mobilise any additional capital from third parties. For export promotion purposes most governments around the world have been working for decades successfully on the basis of ECA guarantee schemes, strategic partnerships and risk sharing with commercial banks. This is not the case for development finance although these same governments are shareholders of MDBs and own bilateral DFIs.

Today development policymakers and DFIs discuss extensively “innovative ways” to involve capital market investors in infrastructure projects in developing countries, but most institutional investors will likely require adequate risk mitigation (e.g. through guarantees) to invest in infrastructure assets in countries with a too low credit rating. Without adequate guarantees it will be difficult to crowd in these investors in infrastructure projects in developing countries.

There are many reasons why guarantees are underutilised. For example for sovereign projects[17] – this is for most MDBs[18] approximately 90% of their business – the pricing of sovereign loans and sovereign guarantees is the same, which implies that a MDB loan is always cheaper than a commercial bank loan/ capital market bond + a MDB guarantee. The interest margin for (sovereign) MDB loans or the premium for (sovereign) MDB guarantees are not risk based, but for all MDB borrowing countries set at the same low non-market based level. It does not take into account that the administration costs of guarantee operations are in general substantially lower than for loans. In MLT guarantee business guarantors cooperate closely with commercial banks, which originate, negotiate and manage the loan and relationship with the borrower. Commercial banks also have to ensure that social and environmental risks in a project are adequately managed. DFI lenders have to do all the work by themselves and incur therefore higher administration costs than guarantors.[19]

In the commercial market PRIs offer for comprehensive cover premiums, which roughly range between 70–85% of the interest rate margin of commercial bank loans. The margin retained by banks covers the counterparty risk on the insurer, the uncovered part of the loan, administration costs incurred by the bank and a profit.

The current discriminatory pricing practices of MDBs for sovereign loans / guarantees are therefore a huge disincentive to make use of guarantees.

In the private sector operations of MDBs, lending is also the dominant form of support. MIGA is the largest multilateral guarantee provider, but then limited to political risks. IFC has a partial credit guarantee programme, which can provide comprehensive cover (including commercial risks), but it is hardly used. In DFI private sector operations lending is preferred and mobilisation of funds from third parties is mainly done through A/B loan programmes. Apart from inconsistent pricing practices and a bias towards lending there are various other internal and external constraints for the multilateral DFI community that hinder the optimal utilisation of guarantees. It is important to address these issues to enhance the guarantee operations and strengthen the mobilisation impact of multilateral DFIs.

If for example leading MDBs instead of loans would provide 90% partial credit guarantees, they would mobilise 10% of non-developmental sources of capital. Taking into account the current loans outstanding of leading MDBs, this would imply $42 billion[20] of additional finance for development, which would obviously assist in bridging the financing gap for infrastructure, climate change and UN SDGs.

***The Addis Ababa Action Agenda Financing for Development (July 2015)***
*"An important use of international public finance, including ODA, is to catalyse additional resource mobilisation from other sources, public and private"*

*It can also be used to unlock additional finance through blended or pooled financing and risk mitigation, notably for infrastructure and other investments that support private sector development."*

An important regulatory barrier – in particular for bilateral DFIs – is the fact that guarantees are not adequately recognised within the ODA[21] framework of the OECD DAC. ODA measures development finance flows and guarantees are contingent liabilities, which only lead to a financial flow when a claim is paid. This clearly shows that the current ODA definition is out dated and hinders innovation[22] of development finance. A revision of the definition – by including guarantees as viable ODA instruments – is therefore urgently needed.

## The strategic country dialogues between developing countries and DFIs

It is common practice within the DFI community to develop together with governments of developing countries a country strategy on how to finance the development objectives of a country. In these so-called country strategy dialogues the discussion is focused on the development priorities of governments and how much development finance (only in the form of loans and grants) can be obtained from the DFI and other potential donors. This is subsequently described in a Country Strategy Paper, which outlines the cooperation between a DFI and a relevant developing country for a period between in general 3–5 years.

Whether the development objectives can be financed through other (market-based) sources of capital (e.g. commercial banks, capital market, and / or ECAs/ PRIs) and how scarce DFI capital can mobilise these other sources of capital (e.g. through guarantees and risk transfer) are unfortunately not part of this dialogue or the country strategy papers. This gap in the dialogue leads to the situation that alternative sources of finance and DFI guarantees are overlooked and that scarce non-market based DFI finance is sometimes "crowding out" market-based finance. It is even likely that for some aid recipient countries market-based finance is complementary to non market-based development finance. But should this not be the other way around?

***World Bank Global Financial Development Report 2015 / 2016: Long-Term Finance.***
*"Mobilising private long-term finance requires a different approach than direct financing.*

*MDB interventions need to support, and not replace or undermine, the formation of sustainable markets"*

In the world of officially supported export credits a so-called commercial viability test has been developed to avoid that tied concessional loans crowds out commercial finance[23]. This test ensures that non-market based finance operates complementary to the market. It would be in the interest of the international aid community (DFIs and OECD DAC) and developing countries to develop a similar commercial viability test for untied aid. In this way it can be avoided that scarce non-market based funds are unintentionally crowding out private capital. It will also contribute to define more precisely the complementary role of non-market based DFI finance and enhance the developmental impact of DFI operations. This is obviously of great importance to developing countries.

Other sources of capital and how they can be tapped should therefore be part of the dialogue with aid recipient countries. Given the limited knowledge about alternative (commercial) sources of finance and how guarantees can be used to mobilise these sources within many DFIs, ministries of development cooperation and aid recipient countries capacity building is crucial.

## Potential topics for cooperation DFIs and Berne Union members

As explained both worlds hardly know each other. So apart from addressing the strategic DFI topics mentioned above it is important to start with a dialogue at senior level between the aid community and official ECAs and explore potential areas for cooperation. Here below follows a list of topics where DFIs and BU members could potentially cooperate with one another, but very likely the suggested dialogue will provide much more interesting opportunities.

**1. Insurance for DFI loan exposure and reinsurance for DFI guarantee exposure.**
Like commercial banks MDBs could cover part of their loan / guarantee exposure with ECAs and PRIs. A good example is MIGA, which reinsures approximately 40% of its gross exposure with ECAs and PRIs. If leading MDBs would follow this practice approximately $169 billion of additional finance (40% of $422 billion) could become available for development. Important is as well that through enhanced cooperation MDBs could not only mobilise additional funds for their borrowing member countries, but likely also at terms and conditions that are more favourable than what ECAs and PRIs normally offer (e.g. longer tenors and lower premiums). The preferred creditor status of MDBs warrants for a more favourable coverage than for a commercial bank loan[24]. Enhanced cooperation has therefore two important benefits namely: more capital for development and at better terms and conditions[25].

**2. Development of A/B loans for sovereign borrowers.**
A/B loans in which the A part is funded by a DFI and the B part is funded by commercial financiers, are currently mainly utilised by MDBs, such as IFC, EBRD and ADB, to finance private sector projects. The DFI acts as lender of record for B loan participants and B loan providers benefit from the preferred creditor protection of the DFI. Given the arranger role of the DFI the B loan can be reported as mobilised capital by the DFI. Obviously the risk mitigation provided through A/B loans is much lower than through DFI guarantees and in general the tenors and other terms of conditions of B loans are less favourable than commercial bank loans that benefit from DFI guarantees. This is mainly caused by the limited risk mitigation effect and limited solvency benefits of A/B loans.

A/B loans are currently not used for the financing of public sector infrastructure projects. It is important to explore potential cooperation between DFIs, commercial banks, ECAs and PRI's in this area. ECAs and PRIs could cover part of the sovereign B-loans. The structure implies a selective sharing of the preferred creditor status, but this is nothing new. In 2015 IBRD/ IDA shared its preferred creditor status through its revolving $400 million guarantee for a $1 billion 15 year sovereign bond for Ghana[26] and MIGA has its NHSFO cover, which has amongst others been used to cover a commercial bank loan to the government of Bangladesh.[27]

**3. Blending.**
Blending concerns the utilisation of ODA grant money to mobilise financing for development. In particular the EU[28] makes use of blending, but the vast majority of the grant money that is currently used is only directly mobilising finance of EU DFIs and not capital from non-development financiers, such as ECAs and commercial banks. It is important to open the blending facilities to ECAs and commercial banks in particular to increase the availability of finance to relatively high-risk markets. For example first loss guarantees to ECAs for business with high-risk countries could increase the availability of MLT finance for these countries. ECAs could also participate in untied DFI concessional loans, which benefit from ODA subsidies to achieve concessional interest rates (mixed credits). This can contribute to freeing up DFI capital, which can subsequently be used for other (non-trade related) development objectives.

**4. Utilisation of OECD ECA pricing system by DFIs.**
Both DFIs and ECAs are backed by financial resources from governments. Both are public sector finance institutions.

**There is tendency within the aid community to narrow the discussions on the mobilisation of private capital to the development of public private partnerships (PPPs), in particular through project finance.**

DFIs currently provide non-market based loans to sovereign borrowers and market based loans to other (mainly private) borrowers. They sometimes compete with ECA supported financing. In order to avoid distortion of competition between public sources of finance caused by pricing differences and to strengthen the complementary role of DFIs, DFIs should consider applying the OECD minimum premium system for the pricing of their MLT cross-border trade related lending and guarantee operations. This can be easily implemented for the private sector operations of DFIs, because they apply market based pricing, but requires likely a structural change in the practices of DFI sovereign lending.

At the same time the pricing of direct lending in the OECD premium framework needs to be reviewed, for the pricing difference with guarantees / insurance does not accurately reflect market practices and the lower operational costs of guarantors / insurers. Furthermore, an adequate premium discount for ECA cover provided to MDBs with a preferred creditor status has to be developed.

**5. Strategic cooperation, coordination & information sharing.**

5A. Input for country strategy dialogue.
As mentioned before the country strategy dialogues between DFIs and aid recipient countries cover currently only development finance. Market-based finance alternatives including ECA or PRI backed financing are not part of the dialogue. In the interest of developing countries it is important that DFI Country Strategy Papers[29], describe in detail all market based financing alternatives that are available for a country. This should include financing options in domestic and international bank and capital markets and international ECA support. Furthermore, it should include how DFI guarantees can be used to mobilise these sources. This will assist developing countries and DFIs to identify which development priorities can potentially be supported by ECAs/ EXIM banks. Obviously this concerns mainly projects that require imports of goods and services from abroad. DFI support can then be focused on financing development priorities of the government, which lack an import component (and therefore also likely no ECA support).

In requests for financing of individual projects DFIs should consider the potential of ECA support. They can opt to buy ECA cover for their loans or guarantees that are used to finance imports of goods of services or cooperate with commercial banks (co-arranger role?), who can arrange the ECA / PRI cover. In this way more financing could become available for development.

5B. Developmental impact of ECA business.
ECAs should consider describing in their annual reports the developmental impact of their operations and how they contribute to the UN SDGs. In this area ECAs can learn a lot from the DFI community.

5C. MLT financing issues in developing countries.
Both DFIs and ECA face challenges in financing projects in developing countries. It would be good to share experiences with one another with the objective to feed the dialogue between DFIs and developing countries so that important issues can be addressed at the appropriate government level and incorporated in country programmes of DFIs. This could include regulatory issues in a country (e.g. legal PPP framework), the role of the public sector in PPP projects and various constraints or complexities in underwriting public and private sector infrastructure projects. Obviously a structural exchange of information on country specific issues will also have benefits for both ECAs and DFIs. It will assist them in underwriting concrete projects.

5D. Reliable credit information about sub-sovereign borrowers and state-owned enterprises (SOEs).
In many countries governments are not only privatising infrastructure through a.o. PPP structures but also decentralising responsibilities to lower levels in the public sector: i.e. from central government to sub-sovereign level (e.g. municipality) or a SOE. This implies a.o. that in many PPP projects commercial banks and ECAs are supposed to accept sub-sovereign off take risks without a guarantee from the government. It also implies that more sub-sovereign entities act as borrower or guarantor in typical public sector infrastructure projects, whereas in the past these projects benefitted from sovereign guarantees. The decentralisation strategy of governments can only be successful and will allow them only to refrain from providing sovereign payment guarantees, if and when the sub-sovereign entity or SOE is financially

sustainable and able to stand on its own feet. If that is not the case decentralisation and PPP's with unsustainable sub-sovereign contract parties will fail. The projects will remain unbankable. DFIs, ECAs and governments in developing countries have a joint interest to increase the number of bankable sub-sovereign public sector infrastructure projects.

DFIs and ECAs could share information with one another about acceptable and unacceptable sub-sovereign and SOE borrowers and the issues that they face in underwriting these (potential) borrowers. This information could subsequently be shared with governments in developing countries so that they – in close cooperation with DFIs – can take appropriate action

**The two worlds of development finance and ECA finance seem to operate in splendid isolation and opportunities for enhanced cooperation are not explored and used to their fullest potential.**

towards self-sustainability of sub-sovereign entities and the SOE sector. Obviously experiences in underwriting sub-sovereign and SOE risks can be shared on a no names basis so that sensitivities with individual ECAs or DFIs can be avoided.

The Berne Union could play an important intermediary role in strategic dialogue.

**6. SMEs and access to finance.**
In many countries the SME sector is facing challenges in obtaining finance. For that reason many governments, ECAs and DFIs have developed special SME programmes to support the SME sector. In this area ECAs and DFIs can learn from each other.

Noteworthy is that various ECAs across the globe, in particular the three large private insurers Euler Hermes, Coface and Atradius, have substantial short-term (ST) credit insurance programmes that cover trade finance all over the world. The vast majority of these ST trade credit insurance business concerns supplier credits which are covered on a portfolio basis. As a consequence, the ST insurers have a large database with reliable credit information on many buyers/ borrowers all over the world among which many SMEs. This data can be used for underwriting purposes to assist DFIs and governments in developing countries to develop successful SME finance or guarantee facilities.

**7. Setting up ECAs and / or EXIM banks in developing countries.**
People in the business of international trade finance are fully aware how important ST and MLT credit insurance and finance are for the development of countries. Exports generate hard currency income for countries, tax income for governments and create sustainable jobs. This explains why many governments have set up ECAs and / or EXIM banks in their country. These institutions form an important part of the financial infrastructure of a country.

Still a lot developing countries lack an adequate ECA or EXIM bank. In this area DFIs, governments and ECAs could cooperate with one another in setting up new ECAs/ EXIM banks or to assist existing ECAs / EXIM banks to enhance their operations. It can create a win-win for all.

**8. Supporting south-south trade and investments.**
DFIs could focus their support on south-south trade and investments where the exporting country lacks an ECA / or EXIM bank or where the national ECA or EXIM bank faces constraints in insuring / financing trade and investments. DFIs could act as guarantor for south-south trade and investments or counter-guarantee guarantees from ECAs with a too low credit rating. By doing that they would support development in both exporting and importing developing countries.

## Concluding remarks

As explained closer and better coordinated cooperation between DFIs and ECAs is critical to increase the availability of financing for development. This is not only in the interest of DFIs, ECAs and developing countries, but also of developed countries of which many are major shareholders of DFIs. Many developed countries increasingly face challenges in their own country, which are directly or indirectly linked to problems and challenges in developing countries. Migration caused by war and civil unrest and likely to increase due to climate change is just one example. Fundamentalism and terrorism, caused by poverty and a lack of knowledge, freedom and a sustainable future, affects all countries. Economic downturns of major developing economies negatively affect international trade and investments. Developed countries have a clear self-interest to further enhance the development of developing countries.

It is therefore time for a structural dialogue between the international aid community and BU members, which should primarily focus on what can and should be done to mobilise more resources for developing countries. Let's think outside the box, work together and create a 1+1=3 in the interest of sustainable development for both developing and developed countries.

Where there is a will, there is a way, so it must be possible to move successfully forward. The UN SDGs, which include infrastructure, climate change, partnership for development and the importance of mobilisation provides the direction about what needs to be done, so it is now primarily a matter of bringing people and organisations together and build the necessary bridges between them. ■

## Notes

1 There are multilateral and bilateral DFI's the most well known multilateral DFI's are IBRD/IDA, IFC MIGA, ADB, IaDB, AfDB, EBRD and EIB. Examples of bilateral DFIs are public sector development banks / agencies such as KfW (Germany) and AfD (France) and private sector development banks such as DEG (Germany), Proparco (France) and FMO (the Netherlands).

2 See: http://www.worldbank.org/en/programs/global-Infrastructure-facility

3 At Copenhagen in 2009, developed country parties to the United Nations Framework Convention on Climate Change (UNFCCC) committed to a goal of mobilising jointly $100 billion a year by 2020 from public and private sources to support climate action in developing countries.

4 UNCTAD estimates that the UN SDGs require a total investment of $2.5 trillion a year over the next 15 years. This includes investments for infrastructure and climate change.

5 This includes private capital and capital from public non-developmental sources such as official ECAs and sovereign wealth funds.

6 Many governments in the world have set up an official ECA with the objective to support exports and foreign investments of their national business community.

7 The IISS-system has been developed by the Sustainable Infrastructure Foundation (SIF), which acts as executing agency for all participating development banks among which ADB, AfDB, BNDES, DBSA, EBRD, IaDB and the World Bank group.

8 See: http://www.worldbank.org/en/news/press-release/2016/08/09/81-billion-mobilised-in-2015-to-tackle-climate-change—-joint-mdb-report. It is interesting to note that the press release speaks about mobilisation by MDBs whereas the report itself refers to cofinancing in general.

9 Among all MDBs only ADB reports under its guarantee business the uncovered part of the loan as mobilised capital. MIGA reports the covered exposure (which includes covered principal loan amount and interest). ADB considers insurance of loan exposure and reinsurance of guarantee exposure as a viable form of mobilisation. Although MIGA is very active in reinsurance, the reinsurance business is not reported as mobilised capital.

10 For multilateral insurers such as MIGA, ATI and ICIEC risk transfer through reinsurance is a common practice. For most DFIs that mainly provide loans this is not the case. Only a few DFIs make use of risk transfer techniques, among others ADB for its ST Trade Finance Program. Risk transfer for MLT DFI financing / guarantees is less common.

11 See report “ infrastructure productivity: How to save $1 trillion a year“ by Mc Kinsey in 2013.

12 It is noteworthy that most PPP projects in developing countries concern electricity generation / energy and telecom projects. See the PPI database of the World Bank.

13 Not only the exposure of IBRD/IDA but also exposure of other MDBs is concentrated on middle income countries where ECA and PRI cover is in general available.

14 This figure concerns the MLT exposure of all members of the Berne Union, which is the leading global association of credit and political risk insurers. The figure covers both MLT officially supported export credits and MLT investment insurance. It is estimated that at least 80% of the MLT business of BU members concerns business with developing countries

15 For example in the OECD DAC aid donor countries discuss the developmental impact of their activities. In those discussions only multilateral and bilateral organisations with a formal developmental mandate participate. As a consequence official organisations that do not have an explicit developmental mandate such as ECAs are not part of the OECD DAC dialogue. ECAs discuss their operations a.o. within the OECD Export Credit Group and the Berne Union. DFI's do not participate in the OECD export credit and Berne Union meetings.

16 See a.o. G20 / OECD guidance note of diversification of financial instruments for infrastructure and SMEs, July 2016.

17 Sovereign projects are projects in which the central government acts as borrower or guarantor.

18 Examples of MDBs with a large sovereign loan program are: IBRD/IDA, ADB, IaDB, AfDB. The sovereign loan portfolios of EBRD and EIB are substantial as well but are lower than 90% of their total loan portfolio.

19 The operational costs of MIGA are for example substantially lower than those of lending DFIs.

20 The total exposure of IBRD/IDA, IFC, ADB, AfDB, IaDB ,EBRD and EIB (only outside EU) was in 2014 approximately U$ 422 billion.

21 Official Development Assistance (ODA) is the most important form of development aid provided by the international donor community. The current definition recognises grants, concessional loans and financial contributions to MDBs as ODA. Guarantees are only recognised in case of a claims payment.

22 Although the DFI community frequently discusses in general terms “innovative and new ways of financing”, amongst others in the OECD DAC, this regulatory ODA issue has thus far not been solved.

23 See the OECD Arrangement on officially supported export credits.

24 OECD ECAs should recognise that cover for MDB loan or guarantee exposure deserves a lower premium than the regular OECD minimum premium. This deviation from OECD minimum premium rules should be included in the list of “permitted exceptions” of the OECD premium regulations. The lower premium for DFI loan or guarantee exposure is a standard practice among PRIs.

25 The topic that through closer cooperation better terms and conditions can be obtained is not part of the OECD DAC surveys on mobilisation.

26 See IBRD/IDA press release of 18 November 2015 “New World Bank Guarantee Helps Ghana Secure $1 Billion, 15-Year Bond”

27 See MIGA press release of 16 December 2015 “MIGA Guarantee Backs Sirajganj 2 Power Plant in Bangladesh”

28 For more information about EU blending it is referred to the following webpage: http://ec.europa.eu/europeaid/policies/innovative-financial-instruments-blending_en

29 Within the World Bank the Country strategy paper is called a Country Partnership Framework (CPF).

# Digital trade: Wish, vision or reality?

## The blockchain euphoria!

**By Urs Kern, senior manager, corporate business, EMEA, SWIFT**

The latest studies and publications are now talking about the digital revolution in foreign trade. In an age where payment transactions, cash management and treasury are largely processed digitally, foreign trade processing is still paper-based – and yet foreign trade has dramatically changed since the 1990s at the latest. Nowadays, exporters and importers are linked up to one another in complex value chains. Information about inventory and supplier needs is recorded and exchanged digitally. Although tracking & tracing functionalities allow merchandise shipments to be traced, accompanying documents are recorded and sent in paper-based form. The United Nations Conference on Trade and Development states that 60 to 70% of all data elements must be recorded several times. All of this leads to high inefficiency characterised by long processing times and high risk of error. The paper-based document-sending process, in particular, can take several days – if not weeks – under some circumstances.

### Requirements for financial service providers

Naturally, financial service providers are especially important in foreign trade. They support their customers' value chains by assuming risks – whether they are counterparty or country risks – and the provision of liquidity in the form of financing, letters of credit, collections, and guarantees, which are financing and risk protection instruments that are hundreds of years old. In recent decades, hardly anything has changed in paper-based processing, apart from the technical recording in back office systems. The sending of documents under a letter of

Urs Kern

credit or collection is done by mail or courier service. Banks nowadays certainly offer some of their customers the presentation of their documents in electronic form as image files (e.g. PDF) for preliminary examination or even printing it out remotely on behalf of the customer. However, the actual border-crossing dispatch between banks takes place in paper-based form, as before.

The relatively high processing costs for the banks that are associated with this are reflected in the processing fees that must be billed to the customer. This is certainly one of the reasons why the demand for these traditional documentary payment instruments has been constantly diminishing relative to foreign trade development and has been replaced by the open account form of payment. Nonetheless, these instruments are still extremely important in sensitive business fields (such as commodity, project, and plant and equipment financing).

### Existing digital foreign trade initiatives

The first paperless trade processing initiatives are now more than 30 years old. In this regard, international organisations like the WTO (World Trade Organisation), UN/CEFACT (United Nations Centre for Trade Facilitation and Electronic Business), UNECE (the United Nations Economic Committee of Europe), and others have implemented programmes and standards, and published specifications and guidelines.

It is not surprising that owing to their strong trade activity, Asian countries can be described above all as trendsetters for paperless trade. For example, as early as in the 1990s, South Korea initiated a project for automating the sector's overarching trade activities. In 2003, the National Paperless Trade Facilitation Committee was established, made up by both government representatives and private sector companies. Finally, u-TradeHub, a platform for paperless trade processing, was introduced in 2007.

The platform provides a system for Korean companies through which they can process all activities related to foreign trade – including marketing, customs clearance, foreign exchange trading, and payments transactions. The portal also facilitates the electronic drawing up and sending of trade documents like bill of lading, certificate of origin, and insurance certificate.

The corresponding trends can be seen in other Asian countries as in Taiwan (Trade-Van) or Hong Kong (Trade-Link), for example. Meanwhile, twelve APAC countries have joined together to create a supranational network, the Pan-Asian E-Commerce Network or PAA.net.

In customer-to-bank communication, the SWIFT standards (MT798) are worthy of a special mention because they at least allow the electronic exchange of letter of credit and guarantee data in a uniform multi-bank standard.

The initiatives described above and a number of others have certainly been successful in partial sectors. Thus, for example, customs clearance is now electronic in many countries, but so far there has not been a revolution in the digital foreign trade world. At best, one can talk about an evolution. The reasons lie in the complexity and the specific requirements.

## Requirements for digital foreign trade

In principle, the following aspects and characteristics of foreign trade and its processing must be considered:

**In recent decades, hardly anything has changed in paper-based processing, apart from the technical recording in back office systems.**

***1. Tracking & tracing***

Digital trade is basically about data exchange and thus about data telecommunication. Unlike conventional telecommunication, however, the receipt of data is not enough, as its traceability is also important. Data possession is frequently associated with rights such as the right to the goods, for example. In this respect, data senders and recipients as well as process participants, if applicable, must be able to trace the origin of the data, its current location right now and who possesses it.

***2. Number of data sets***

Studies have demonstrated that up to 27 different companies and participants are involved in the foreign trade process with more than 40 documents and 200 data elements. Unlike what happens in payment transactions where, for example, only one payment transaction file must be transmitted with a limited data amount, the foreign trade process is a lot more complex. The triggering and processing of the payment is only the final step. Before that, a lot of data (e.g. from invoices, transportation documents, certificates, etc.) must be exchanged, which is linked to one another as well. Discrepancies quickly lead to process inefficiencies and even to delayed merchandise deliveries.

***3. Trust***

Foreign trade has always been based on trust. If there is no full trust, one can fall back on risk protection instruments such as the letter of credit, for example. In the digital process the term trust must be expanded to data quality, data origins and security. Risk

**It is not surprising that owing to their strong trade activity, Asian countries can be described above all as trendsetters for paperless trade.**

protection instruments should be set aside when data is submitted instead of documents.

***4. Interoperability***

Considering the number of process participants and the quantity of data, a uniform platform as well as formats and standards seem illusory. In this respect, interoperability must be achieved to secure an exchange through various platforms and applications.

***5. Compliance***

International trade is covered by a host of regulations, such as know-your customer and anti-money-laundering policies, and trade embargoes. Such regulation is becoming not only more comprehensive and changeable but also more strictly policed, exposing not only financial institutions but also corporates to the risk of reputational damage and fines. Effective compliance is thus a key driver of performance and a significant operational burden. Filtering technologies like the one from SWIFT should be embedded, respectively linked in or to any digital trade solution.

Furthermore, the different views on foreign trade processing must be taken into account, given that it is not possible to consider it as purely traditional transaction business. The significance lies in the value and complexity of the underlying transaction – that is, the goods. Therefore, the basic requirements for the creation of a business case are not the same for all participants. So, where does the euphoria for the subject of digital trade that is being observed come from? The answer lies mainly in blockchain technology.

## Blockchain

Simply expressed, blockchain is a database subdivided into different transaction blocks. The blocks are important, as they contain a record of the latest transactions. The blocks are stored in various distributed ledgers (peer-to-peer), linked to one another, and encoded using highly complex cryptographic methods. The blockchain is only valid when all blocks lead back to the genesis block.

A very high potential is attributed to this distributed approach precisely in international business, because unlike today, no varied central networks have to be maintained and linked up. Through this distributed approach, the problem of tracing a foreign trade transaction described in this article is secured.

Many banks are currently conducting feasibility studies (e.g. HSBC together with the Bank of America Merrill Lynch and the Infocomm Development Authority of Singapore). Everybody agrees that blockchain technology is, in theory, an outstanding approach for changing foreign trade processes sustainably in the future.

Further initiatives employ a partially different approach but still pursue the same path. Thus, providers like essDOCS and Bolero have been on the market for a long time with an electronic bill of lading. The owner of the bill of lading is stored in the "title registry", which also secures the transfer of the right of ownership.

**Where does the euphoria for the subject of digital trade that is being observed come from? The answer lies mainly in blockchain technology.**

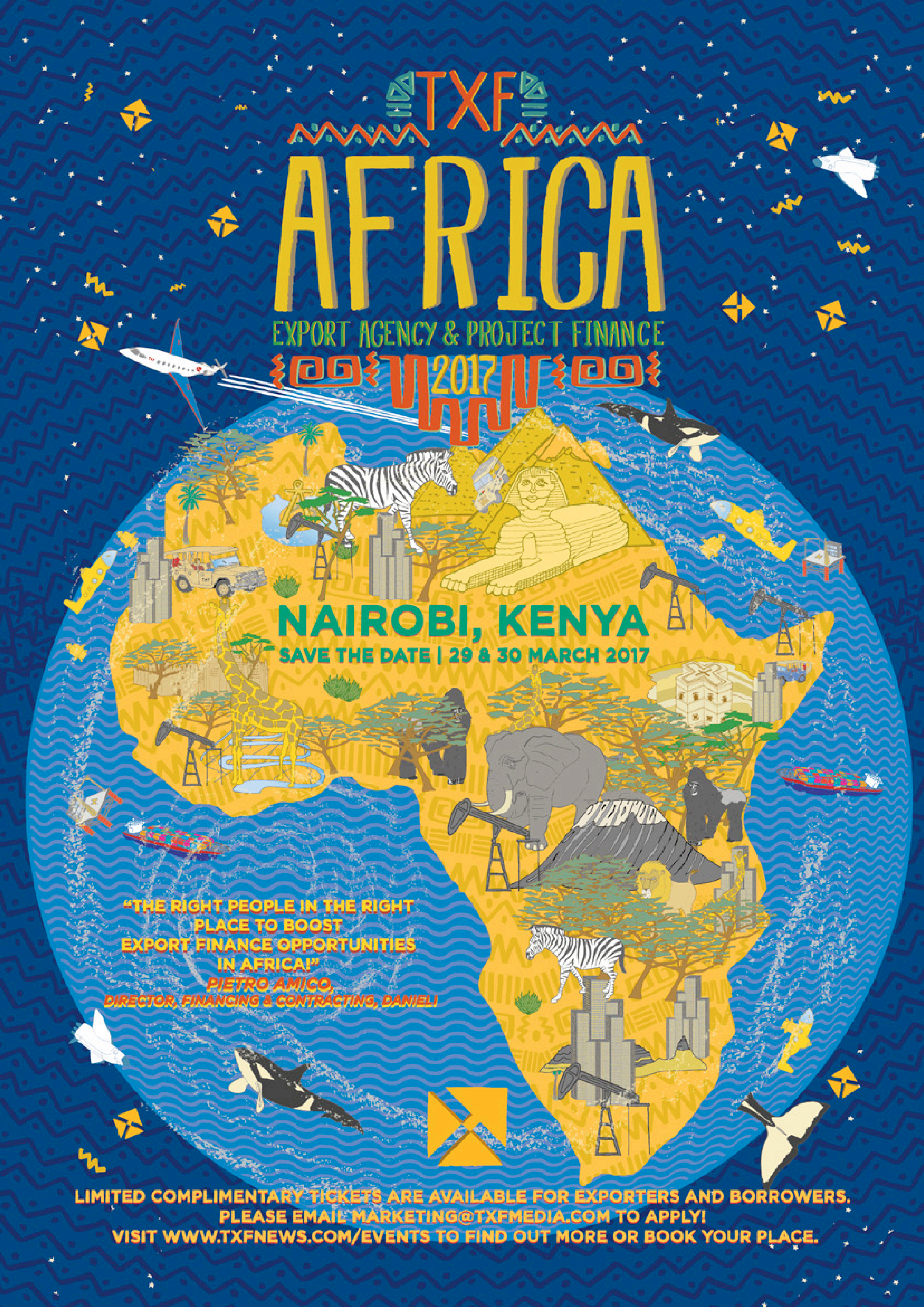
The Bank Payment Obligation (BPO) developed jointly by the ICC and SWIFT is an irrevocable undertaking to pay geared to the submission of consistent data. Since the BPO was introduced two years ago, banks such as the UniCredit Group and Commerzbank have already successfully executed initial transactions based on this new payment guarantee instrument.

## Conclusion

Surely, total paperless trade processing is nowadays equally more vision and wish than reality. To what extent the new technologies will really lead to a revolution of foreign trade processing remains to be seen. Feasibility studies must first demonstrate their usefulness in practice. The complexity of foreign trade business that must be resolved is high. At any rate, however, the potential offered by Blockchain Technology & Co. is there and maybe the future lies in combining various approaches. There are many visions right now, and without a vision there is no reality – or as the Swiss writer Friedrich Dürrenmatt (1921 – 1990) already said: "You should never stop imagining the world that would have been the most reasonable one".■

# 4

# Directory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# Berne Union Members

The Berne Union has 82 member companies (including 3 observers) from around the world. The membership is diverse – member organisations may be private or state linked, small or large. Together, they represent all aspects of the export credit and investment insurance industry worldwide.

The Berne Union member directory has moved online – this allows us to ensure that member information and contact details are always current and accessible. For contacts and more detailed information about each member please visit

**http://www.berneunion.org/about-the-berne-union/berne-union-members/**

**ABGF** Brazil
Agência Brasileira Gestora de Fundos Garantidores e Garantias S.A.

**AIG** United States of America
American International Group, Inc.

**ALTUM** Latvia
Development Finance Institution Altum

**AOFI** Serbia
Serbian Export Credit and Insurance Agency

**ASEI** Indonesia PT.
Asuransi Asei Indonesia (Asuransi Asei)

**ASHRA** Israel
Israel Export Insurance Corp Ltd

**ATI** Multilateral
African Trade Insurance Agency

**ATRADIUS** The Netherlands
Atradius NV

**BAEZ** Bulgaria
Bulgarian Export Insurance Agency

**BANCOMEXT** Mexico
Banco Nacional de Comercio Exterior S.N.C.

**BECI** Botswana
Export Credit and Guarantee Company

**CESCE** Spain
Compania Espanola de Seguros de Credito a la Exportacion

**CHUBB** Switzerland
Chubb Insurance Company

**COFACE** France
Compagnie Française d'Assurance pour le Commerce Exterieur

**COSEC** Portugal
Companhia de Seguro de Créditos, S.A.

**CREDENDO GROUP** Belgium

**DHAMAN** Multilateral
The Arab Investment & Export Credit Guarantee Corporation

**ECGA O** Oman
Export Credit Guarantee Agency of Oman (S.A.O.C.)

**ECGC** India
Export Credit Guarantee Corporation of India Ltd

**ECGE** Egypt
Export Credit Guarantee Company of Egypt

**ECIC SA** South Africa
Export Credit Insurance Corporation of South Africa Ltd

**ECICS** Singapore
ECICS Limited

**ECIE** United Arab Emirates
Export Credit Insurance Co. of the Emirates

**ECIO** Greece
Export Credit Insurance Organization

**EDC** Canada
Export Development Canada

**EFIC** Australia
The Export Finance and Insurance Corporation

**EGAP** Czech Republic
Export Guarantee & Insurance Corporation

**EGFI** Iran
Export Guarantee Fund of Iran

**EH GERMANY** Germany (State)
Euler Hermes Deutschland AG

**EH GROUP** Germany (Private)
Euler Hermes SA, represented by
Branch Office Euler Hermes Germany

**EIAA** Armenia
Export Insurance Agency of Armenia

**EKF** Denmark
Eksport Kredit Fonde

**EKN** Sweden
Exportkreditnämnden

**EXIAR** Russia
Export Insurance Agency of Russia

**EXIM HUNGARY** Hungary
Hungarian Export-Import Bank Plc.
Hungarian Export Credit Insurance Plc.

**EXIM J** Jamaica
National Export-Import Bank of Jamaica Limited

**EXIM R** Romania
Eximbank of Romania

**EXIMBANKA SR** Slovak Republic
Export-Import Bank of the Slovak Republic

**EXIMGARANT** Belarus
Eximgarant of Belarus

**FCIA** United States of America
FCIA Management Company, Inc

**FINNVERA** Finland
Finnvera Plc

**GIEK** Norway
Garanti-Instituttet for Eksportkreditt

**HBOR** Croatia
Croatian Bank for Reconstruction & Development

**HISCOX** Bermuda
Hiscox Political Risk

**HKEC** Hong Kong
Hong Kong Export Credit Insurance Corporation

**ICIEC** Multilateral
Islamic Corp for the Insurance of Investment &
Export Credit

**IGA** Bosnia and Herzegovina
Investment Guarantee Agency

**JLGC** Jordan
Jordan Loan Guarantee Corporation

**KAZEXPORTGARANT** Kazakhstan
KazExportGarant Export Credit Insurance
Corporation

**KREDEX** Estonia
KredEx Credit Insurance Ltd.

**KSURE** Korea
Korea Trade Insurance Corporation

**KUKE** Poland
Export Credit Insurance Corporation Joint Stock
Company

**LCI** Lebanon
Lebanese Credit Insurer

**LPEI** Indonesia
Indonesia Eximbank

**MBDP** Macedonia
Macedonian Bank for Development Promotion

**MEXIM** Malaysia
Export-Import Bank of Malaysia Berhad

**MIGA** Multilateral
Multilateral Investment Guarantee Agency

**NAIFE** Sudan
National Agency for Insurance & Finance of Exports of Sudan

**NEXI** Japan
Nippon Export and Investment Insurance

**NZECO** New Zealand
The New Zealand Export Credit Office

**ODL** Luxembourg
Luxembourg Export Credit Agency

**OeKB** Austria
Oesterreichische Kontrollbank Aktiengesellschaft

**OPIC** United States of America
Overseas Private Investment Corporation

**PICC** China
People's Insurance Company of China

**PwC** Germany
PricewaterhouseCoopers AG

**SACE** Italy
Servizi Assicurativi del Credito all'Esportazione

**SEP** Saudi Arabia
Saudi Export Program

**SERV** Switzerland
Swiss Export Risk Insurance

**SID** Slovenia
SID Inc, Ljubljana

**SINOSURE** China
China Export & Credit Insurance Corporation

**SLECIC** Sri Lanka
Sri Lanka Export Credit Insurance Corporation

**SONAC** Senegal
Société Nationale d'Assurances du Crédit et du Cautionnement

**SOVEREIGN** Bermuda
Sovereign Risk Insurance Ltd

**TASDEER** Qatar
Qatar Export Development Agency

**TEBC** Chinese Taipei
Taipei Export-Import Bank of China

**THAI EXIMBANK** Thailand
Export-Import Bank of Thailand

**TURK EXIMBANK** Turkey
Export Credit Bank of Turkey

**UK EXPORT FINANCE** United Kingdom
Export Credits Gurantee Department

**UKREXIMBANK** Ukraine
Joint Stock Company the State Export-Import Bank of Ukraine

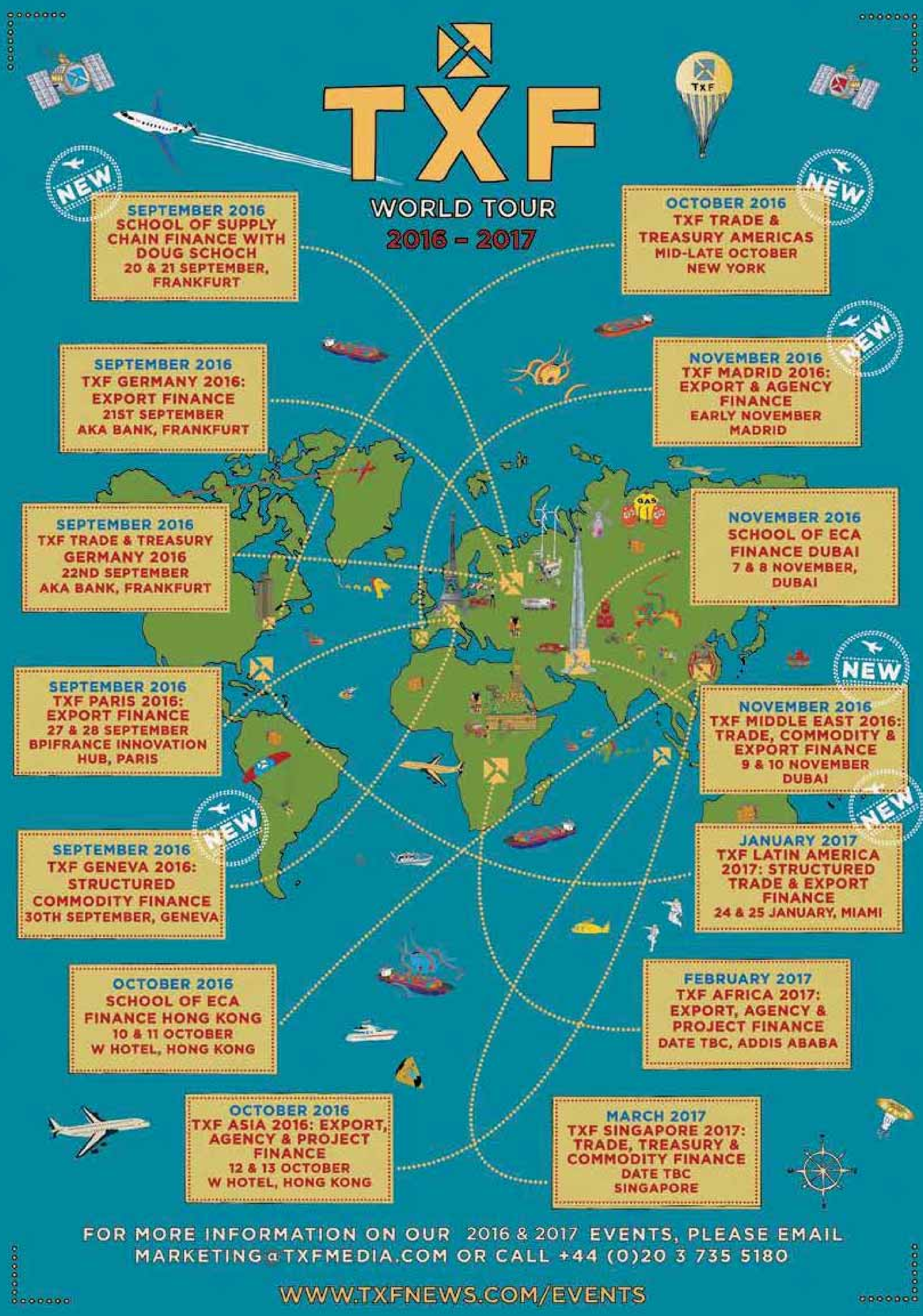
**US EXIMBANK** United States of America
Export-Import Bank of the United States

**UZBEKINVEST** Uzbekistan
Uzbekinvest National Export-Import Insurance Company

**XL CATLIN** United Kingdom
XL Insurance Company SE

**ZURICH** United States of America
Zurich Surety, Credit & Political Risk

# Notes



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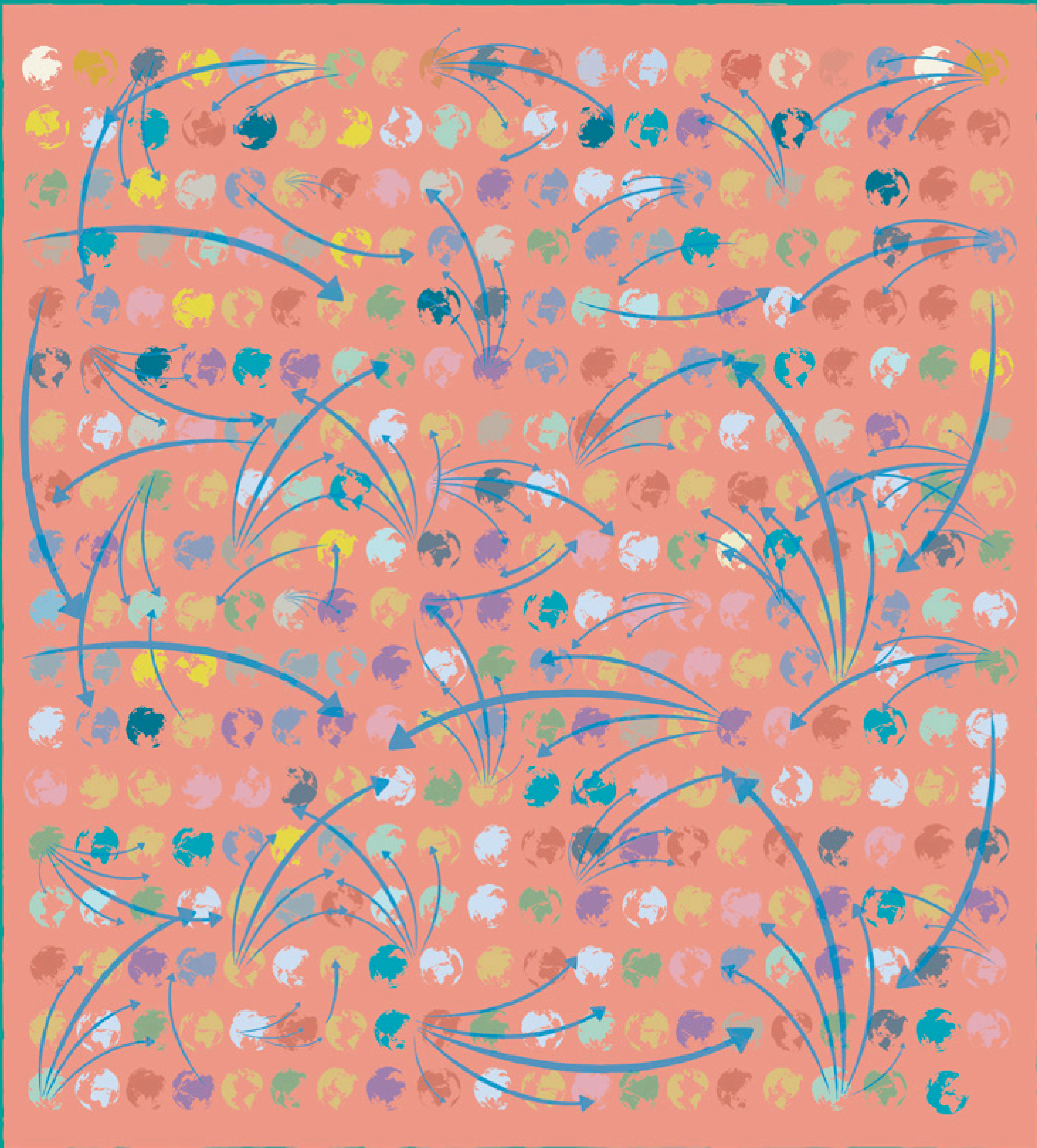

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