



The Commonwealth

# Trade Express

Strategies for Success

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## Developing Robust Export Credit Agencies to Promote Exports

### Introduction

Almost all of world trade relies on access to trade finance. Yet in many countries there is a lack of domestic capacity in the financial sector to support trade, and also a lack of access to the international financial system. The impact of these limitations on a country's trading potential can be very significant. Access to trade finance is therefore critical to increasing exports. It is a truism that export finance boosts exports. Countries which have been successful in relation to exports, including Korea and Brazil, have liberal export finance regimes. Over the past 20 years, India has successfully transitioned from an export-pessimistic model to a reasonably export-friendly policy framework. This transformation is in part because the Reserve Bank of India (RBI) maintained a special dispensation for export finance. Small and medium-sized enterprises (SMEs) in particular have benefited from the liberal finance market, enabling them to access export finance; these companies 'currently contribute about 40 per cent of India's exports'<sup>1</sup>. Through the Sri Lanka Export Credit Insurance Corporation (SLECIC), the Sri Lanka Government requested technical assistance from the Commonwealth Secretariat to enhance the international competitiveness of Sri Lanka's exports and improve the effectiveness of export credit insurance in export development.

### Global Trade Finance Landscape

International trade poses a spectrum of risk, causing uncertainty regarding the timing of payments between the exporter and importer. To an exporter, any transaction is considered a gift until payment is received. To an importer, any advance payment is considered a donation until the goods are received. Hence, the importer wants to receive the goods as early as possible and would like to delay payment for as long as possible, preferably until after the goods are resold in order to generate sufficient income to pay the exporter. In such a scenario, for any exporter to succeed in the international marketplace, it is imperative that it offers its overseas importer desirable sales terms, backed by suitable payment terms that are able to compete successfully against foreign entities. In order to achieve this, there has to be an institutional mechanism in place to minimise

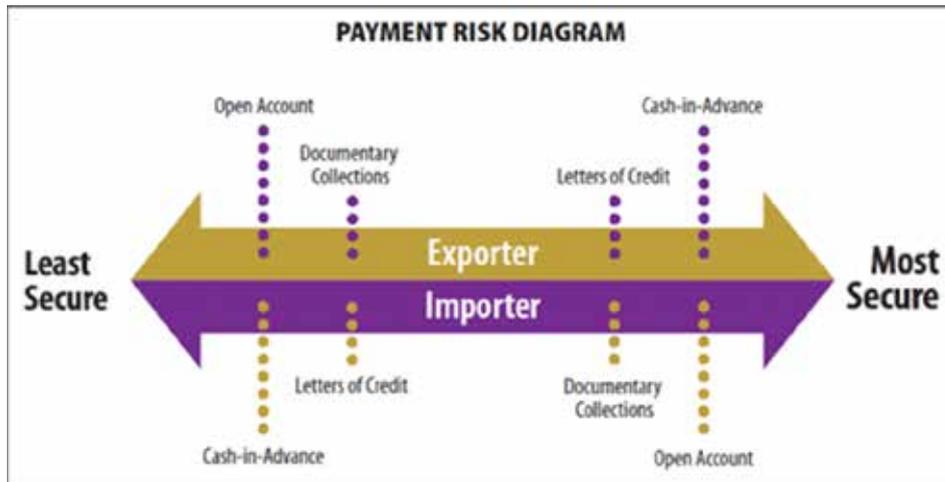
the payment risk, as depicted in Figure 1. There are essentially four primary methods of payment for international transactions, as shown in Figure 1.

According to various estimates, the largest share of global merchandise trade has been financed on an open account basis, in which importers



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Figure 1. The payment risk paradigm



Source: Commonwealth Secretariat (2014), Building Capacity of the Export Credit Insurance Industry: To Enhance the International Trade Competitiveness of Sri Lanka, Commonwealth Secretariat, London, p. 38. Adapted from <https://www.export.gov/article?id=Trade-Finance-Guide-Methods-of-Payment>

pay exporters directly after the receipt of goods, without insurance or intermediation by lending organisations. The cash-in-advance approach is another type of arrangement, but is at the opposite end of the spectrum to the open account approach. Under a cash-in-advance arrangement, importers pay for goods before they are shipped, which burdens the importers with non-performance risk<sup>2</sup>, and also increases pressure on working capital. Bank-intermediated trade finance primarily comprises letters of credit (L/Cs) and documentary collections, and helps both exporters and importers to shift some of the non-payment, or non-performance, risk to banks. Letters of credit are among the most secure instruments available to international traders and represent a commitment by a bank on behalf of the buyer that payment will be made to the exporter, provided that the terms and conditions have been met, as verified through the presentation of all required documents. A documentary collection is a transaction whereby the exporter entrusts the collection of a payment to a remitting bank (i.e. the exporter's bank), which sends documents to a collecting bank (i.e. the importer's bank), along with instructions for payment.

Export finance refers to financial assistance extended by banks and other financial institutions to businesses for the export of products (goods/ services) outside a country or region. Export financing enables micro, small and medium-sized enterprises (MSMEs) to expand their reach to a global audience. Export finance products facilitate

trade transactions and are normally short term in nature. The term, however, varies depending on the items being exported and the type of finance product being made available. Export finance plays an important role in facilitating trade by securing finance in order to manage cash flows, risks and costs, and to raise funds and capital; it also aids the expansion of international trade. Thus, it is different from normal commercial bank lending, mortgage lending and insurance. Typically, importers and exporters look for any competitive advantage that would help them to increase their business. For instance, flexible payment terms can make a product more competitive than similar products from other countries. Similarly, the cost of finance (interest rates and other fees) has a strong effect on price and can render a product uncompetitive in the international market. Hence, export finance becomes an essential element of enhancing export capabilities, and even more so for firms in emerging countries such as Sri Lanka. Export financing can be structured as a secure mode of financing, both long and short term. Trade financing has been used in more than 90 per cent<sup>3</sup> of trade transactions globally (mostly in the form of short-term credit). Thus, export finance is the lifeline of trade because more than 90 per cent of trade transactions involve some form of credit, insurance or guarantee. According to the World Bank<sup>4</sup>, the annual global trade finance market is worth well over US\$15 trillion, given that global trade is worth nearly US\$20 trillion. Export finance facilitates trade by helping to overcome the information asymmetry between

buyers and sellers, enabling them to place their trust in a system whereby sellers are paid under certain conditions and buyers get the products they have paid for.

Export finance contributes to the expansion of international trade through payment facilitation, risk mitigation, financing and the provision of information about the status of payments and shipments. Every export finance transaction involves some combination of these elements, adjusted to suit the circumstances of the particular market or trading relationship. In addition, export finance is less fraught with risks of default. According to the Global Risks – Trade Finance Report 2013, 'out of the nearly 8.1 million short-term trade finance transactions during the 2008–2011 period, fewer than 1,800 defaulted'<sup>5</sup>. This equates to an approximate 0.02 per cent default rate on a transaction basis. Furthermore, the likelihood of default is consistently low across products, with transaction default rates of 0.035 per cent or less for all products. This places further emphasis on the need for a robust export financing system, especially in emerging countries such as Sri Lanka.

Export credit agencies (ECAs) play a pivotal role in promoting and facilitating their country's international trade. ECAs support their country's exports through a variety of financing programmes to help exporters meet global competition effectively and ensure that their exporters do not lose out because of uncompetitive financing packages. Apart from financing, ECAs also provide guarantees and insurance to their country's exporters and export credit lending institutions, thus protecting both from the risks of non-repayment. As government-backed agencies focusing particularly on exports, ECAs offer lower interest rates, premiums and fees for their services than commercial banks or other insurers.

## The export finance landscape of Sri Lanka

A successful economic growth model for an island economy is traditionally export led, with a business-friendly economic environment. As regards the latter, Sri Lanka is acknowledged to be doing better than its peers. However, as regards exports, there are concerns. This is notwithstanding the country's impressive international trade performance over the last decade. The Export Propensity Index

(EPI) – merchandise and services exports as a percentage of gross domestic product (GDP) – has experienced a declining trend in recent years, decreasing from 29 per cent in 2007 to 22 per cent in 2014<sup>6</sup>. This concern is amplified by the structure of the country's exports, which are concentrated on a few traditional products and markets. Sri Lanka's merchandise exports mainly comprise a select set of products (apparel, tea and rubber), and are often targeted at a limited range of buyers, most of whom are in developed-country markets. Further, a substantial proportion of Sri Lanka's exports have a high import intensity<sup>7</sup>.

Finance for exports is not a priority for commercial banks, who continue to lend to exporters based only on the availability of collateral. Certain policy changes in the export credit system are warranted in order to incentivise export growth. Such changes entail risk, and hence the role of export credit insurance assumes significance.

A higher proportion of Sri Lanka's exports are conducted on open account terms. One of the primary reasons for this is that most of the major exporters have long-standing relationships with their overseas buyers. Thus, the risk of default is very low. Further, Sri Lanka's exports are predominantly on cash terms or short-term (less than 3-month) credit terms, with practically no exports on deferred payment terms exceeding 1 year.

Another characteristic of export finance in Sri Lanka is that it is largely collateral driven. The quantum of export finance extended to an exporter is, in the final analysis, limited by the collateral on offer, even if the amount is inadequate to execute the export order in question. Primary interactions with Sri Lankan exporters and their feedback indicate that, quite often, export business has been lost because of either availability or the cost of finance. This is notwithstanding the fact that some banks are reported to provide export order-linked cash-flow financing in select cases.

The institutional framework for export finance in Sri Lanka needs to be strengthened to generate momentum in exports.

## The role of export credit insurance

The purpose of export credit insurance is to offer protection to exporters of goods or services who sell their products on credit terms. The exporter

## Plugging the financing gap

The establishment of an EBSL would provide an institutional response to the financing gap currently faced by exporters, and particularly SMEs; it would impart impetus to export development using credit as a tool, offer information and advisory services, and address the structural weaknesses of Sri Lanka's export system, which include a modest exporter base, a narrow product range, a limited number of overseas buyers, inadequate exportable production and inadequate global value chain linkages.

The proposed EBSL will seek to provide financing solutions to Sri Lankan exporters for viable exports without insisting on collateral, taking SLECIC risk cover as appropriate. It is planned that the EBSL will operate on a mandate that no viable export order will be lost because of a lack of finance.

The proposed EBSL would pay special attention to the needs of medium and small exporters, collaborate with commercial banks to minimise overlap and introduce new financing products.

is insured against losses arising from a wide range of risks, which can be broadly classified as either commercial risks or political risks. In order to protect the insurers against adverse selection, an exporter is usually required to insure its entire book of export orders filled on credit terms, rather than being allowed to seek coverage in respect of countries where the risk is perceived to be the greatest. Export credit insurance provides exporters of goods and services with a significant degree of financial security, thus allowing companies to pursue less cautious export policies by accepting new buyers and entering into new geographical areas, but with a smaller impact from the risks of non-payment and political instability. Indirect effects of the purchase of such insurance might include the use of policies as security against bank loans and other financial arrangements.

SLECIC, the national export credit insurance agency of Sri Lanka, has a narrow client base and limited coverage of the country's exports. Although SLECIC offers a wide range of financial products, there are gaps and there is a need for more products to meet emerging needs. SLECIC covers approximately 5 per cent of Sri Lankan exports. There is a low degree of awareness of SLECIC and its products among the trading community. Consequently, SLECIC decided to review the export credit tools which are currently offered by SLECIC and identify factors which might be causing low or zero uptake by exporters.

## The nature of the project and the project objective

This project was developed in response to a request received from the Sri Lanka Government through SLECIC, and validated by the Department of External Resources of the Ministry of Finance and Planning. The objective was to build the capacity of the export credit insurance industry in order to bring it in line with market demands. The project was conducted in two phases.

In phase 1 of the project, which was concluded in May 2014, a comprehensive trade analysis was conducted and SLECIC was benchmarked against other credit agencies around the world. Gaps were identified in the following areas:

- a. SLECIC's existing product range vis-à-vis the needs of Sri Lankan exporters;
- b. the processes used by SLECIC to address the expectations of banks and exporters;
- c. the policy framework in Sri Lanka regarding export finance.

A number of recommendations were made encompassing policy, new product development and institutional capacity enhancement.

Phase 2 of the project, which was concluded in November 2016, focused on modifying the architecture for export credit to enable it to play its due role in supporting export growth through:

Figure 2. EBSL: products and services



Source: Commonwealth Secretariat (2014), Building Capacity of the Export Credit Insurance Industry: To Enhance the International Trade Competitiveness of Sri Lanka, Commonwealth Secretariat, London.

- a. establishing modalities for operationalising policy changes, in order to support accelerated export growth, the diversification of the export base and the provision of adequate export credit on internationally competitive terms;
- b. the capacity building of SLECIC, in order to improve its outreach to exporters and banks, particularly the underserved segments;
- c. upskilling, in order to support and incentivise SLECIC to carry through the necessary changes in its product range;
- d. recommending mechanisms for the various elements of the export credit system to work in congruence for optimal outcomes.

### Outcomes of the Commonwealth Secretariat intervention

Five stakeholder workshops were held, including a large number of bilateral meetings with government officials, central bank officials, exporters, industry bodies, bankers, independent professionals, experts and international financial institutions. Extensive surveys were also conducted. It was recommended

that SLECIC define its strategic goals to enable objective evaluation. For Sri Lankan exports to grow, there needs to be a vision, with a roadmap. Accordingly, SLECIC needs to adopt a long-term vision, akin to the strategic vision for the country announced by the government in the 'Roadmap for the Financial Sector'.<sup>8</sup>

To achieve this target, SLECIC will need to adopt a slew of business strategies. First, a structured marketing strategy will need to be introduced. A product development team will need to be set up to identify new products that can be introduced on an ongoing basis. This is particularly important as diversification of markets and products by exporters is being attempted. For instance, exposure-based insurance policies, targeting large and high-performing exporters with maximum loss limit and single-buyer limits, may be introduced.

SLECIC needs to renew its pricing policy with a view to aligning its rates of premium with risk perception and business volumes. High-volume, low-risk business should achieve competitive pricing. A no-claim bonus scheme should be introduced to reward customers with no claims, which is common for most insurance companies around the world. The whole turnover policy premium

should set lower specific cover. SLECIC's Board of Directors has been fully informed of the proposed recommendations and is keen to implement the reforms in a short time span.

## Export–Import Bank of Sri Lanka

The two interventions in Sri Lanka revealed the structural weaknesses of Sri Lanka's export system and the limitations to the existing financial system with regard to boosting exports. Apart from a host of recommendations on improving SLECIC's capabilities to enable it to play a more effective role, a modified financial architecture was also proposed, in order to give an impetus to exports in the context of their critical importance to the Sri Lankan economy. The latter proposal included the establishment of an Export–Import Bank of Sri Lanka (EBSL), dedicated to exports, intended to act as the co-ordinating institution for export finance and functioning within the regulatory ambit of the Central Bank (see Figure 2).

At the request of the Minister of Finance, a detailed concept note on the EBSL was prepared and submitted in October 2015. In the national budget announced in November 2015, the Minister of Finance announced the establishment of an EBSL as a public–private partnership, with 25 billion Sri Lanka rupees from the Sri Lanka Government as seed capital. Following a series of consultations between the Ministry of Finance and the Commonwealth Secretariat, it was agreed that the Commonwealth Secretariat would provide technical assistance to the Sri Lanka Government for establishing an EBSL. Initial interventions will include conducting pre-feasibility and feasibility studies. A working group (WG) has been set up to deliberate comprehensively on the formation of the EBSL, so that a clear shape of the bank is available before embarking on a detailed feasibility study and implementation plan. A WG was set up to collect the best available expertise on the subject, from both within Sri Lanka and outside. The WG is tasked with the broad mandate of finalising its key objectives and constitutional aspects so that the shape of the EBSL is well defined.

## Endnotes

1. Export–Import Bank of India.
2. The exporter has the payment but may not correctly perform the contract. For example, the exporter may ship the wrong goods, the wrong quality of goods or the wrong quantity, or they may ship the correct goods but not provide correct documents for destination customs clearance and delivery to the buyer.
3. International Chamber of Commerce (2013), *Global Risks – Trade Finance Report 2013*, ICC Banking Commission, Paris. (International Chamber of Commerce)
4. World Bank (2010), *Trade Finance in Crisis: Should Developing Countries Establish Export Credit Agencies?*, Research Working Paper No. 5166, World Bank, Washington, DC.
5. International Chamber of Commerce (2013), *Global Risks – Trade Finance Report 2013*, ICC Banking Commission, Paris.
6. Central Bank of Sri Lanka. *Quarterly Statistical Review 2015*, Central Bank of Sri Lanka, Colombo.
7. Export production is dependent on a high proportion of imported inputs.
8. Central Bank of Sri Lanka (2014) *Roadmap 2014*, Central Bank of Sri Lanka, Colombo

# Trade Competitiveness Section

The Commonwealth Secretariat's Trade Competitiveness Section (TCS) of the Trade Division provides technical assistance (TA) to member countries for improving their trade competitiveness in global markets. Recognising the limited size of the domestic market in many member countries, TCS has a strong focus on export development, with interventions targeted at the national level and where requested, escalated to the regional and international level. The Section has been recently given added responsibility for implementing the Commonwealth Secretariat's Trade Finance Facility in their work program.

TC's specific areas of expertise include:

1. **Market Access** – Interventions in this area of work aim to secure sustainable market access for priority exports. The Section is helping member states in identifying 'New Products and New Markets' and developing schemes around them to diversify their exports. TA is being provided to many countries on targeted action plans for linking into regional and global value chains. The Section is also helping the member states in their multilateral, regional as well bilateral trade negotiations.
2. **Export Development Strategies** – This initiative supports member countries to design and implement strategic plans for trade competitiveness and export development, underpinned by mechanisms for effective dialogue with governments and non-state actors. National Trade Policies as well as National Export Strategies have been designed for many member states.
3. **Enhancing the development and exports of services** – Exports of services can provide opportunities to create employment, diversify exports, enhance productivity and empower low skill workers. This area of work allows member governments to benefit from the new opportunities created by globalisation and trade liberalisation.
4. **Trade Facilitation** – Trade facilitation encompasses the process of identifying and addressing bottlenecks imposed by the weakness in trade related logistics and regulatory regimes that prevent the timely cost effective movement of goods. To deliver this short term outcome, interventions focus on assisting member countries to reduce the costs of doing business and, as signatories to the WTO, to meet their international obligations in this area. Interventions are made through the development of strategic action plans, benchmark studies and reports, and capacity building in trade facilitation.

The Trade Competitiveness Section works in response to the requests received from the Governments or apex institutions and provides technical assistance to address the above competitiveness issues. Areas of expertise include export diversification strategies; gender sensitisation of trade policies; implications of trade agreements and related policy advocacy; implications and compliance to WTO agreements; GATS and Trade in Services Agreements; Mega FTAs like Trade in Services Agreement (TiSA), Economic Partnership Agreements (EPAs), etc; trade facilitation measures and Trade Facilitation Agreement (TFA) along with cost of compliance to the TFA. For 2015/16, the Section is providing TA to 14 countries with 19 projects.

Trade Express will share information and lessons learned from recent Commonwealth Secretariat interventions. Articles will discuss design and implementation processes; in particular, practical solutions for the perennial problems surrounding appropriate trade policy design, advocacy and strategic trade interventions.

## Forthcoming issue

### Issue 7: Botswana 'Aid for Trade' – matching donor disbursement to National development priorities

"Aid for Trade" has become an important vehicle to assist developing countries improve their trade competitiveness and benefit from the expansion of global markets. The benefits of a liberalised trade regime can however only be fully realised only in an economy with efficient infrastructure linking local producers to domestic, regional and global markets and a regulatory environment that encourages a vibrant private sector. To ensure that donor disbursements align with country's national development objectives, the Botswana AfT strategy identifies priority areas for assistance across sectors and provides strategic guidance for the country to position itself to attract and take advantage of AfT resources in pursuit of its efforts to diversify the economy, create employment and reduce poverty.

## Previous issues

### Issue 5: Exporting professional services: Is there room for small states? The experience of Belize



Technology has made it easier to trade certain businesses and professional services. The global outsourcing industry, which exceeded £100 billion in 2014, continues to expand. Can this industry provide a viable growth stream for small economies? The next issue will consider how the Commonwealth Secretariat is supporting Belize to explore the export opportunities that Business Process Outsourcing provides.

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