PRIVATE SECTOR CROSS BORDER TRADE TO EMERGING MARKET ECONOMIES: HOW CAN EXPORT CREDIT AGENCIES HELP TO MANAGE THE RISKS?

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Abstract
Private sector companies engaging in cross border trade and/or investments in emerging market economies are faced with risks that are different from risks in domestic markets. Emerging markets often offer opportunities for high returns, but at the same time the risks, including both commercial and non-commercial/political risks, can be high. Risk mitigation can thus be beneficial. The article discusses the opportunities and the challenges that private companies may face when engaging in trade and/or investment in emerging markets. It will then discuss options for using risk mitigation instruments offered by export credit agencies (ECAs). The article also discusses recent examples of cross border trade and projects in emerging markets to illustrate how those instruments have been applied in real world situations.

KEY WORDS: Cross border trade and investment, emerging markets, export credit agencies (ECAs), commercial and non-commercial risks, and risk mitigation instruments.

Introduction
Private sector companies who engage in trade and investments in emerging markets are both faced with commercial risks and non-commercial/political risks. Political risks are typically higher in emerging markets than in developed countries. The World Bank’s Multilateral Investment Guarantee Agency (MIGA) recently published a report titled World Investment and Political Risk (MIGA, 2009). This report includes an extensive literature review on foreign direct investment and political risks. The study found that while a degree of ambiguity exists when it comes to the relationship between political risk variables and foreign direct investment (FDI) based on econometric studies, findings based on surveys unequivocally support the view that companies do take into account political risk in their investment decisions (MIGA, 2009). According to the Economist Intelligence Unit in recent years there has been growing evidence that political risk not only features in investment decisions, but is also moving towards the top of corporate agendas, as reflected in various business surveys. This is especially true for emerging markets where generic political risk is identified as main investment constraint (EIU, 2007). A report from Lloyd’s found that global businesses were becoming more concerned about risk from political violence. More
than one third of 154 survey takers said that they were avoiding overseas investments for fear of political violence. This report also stated that business leaders believe political violence risk is real and rising; and concerns about political violence are preventing companies from investing where they would like to invest (Lloyd’s, 2007).

So what is political risk? There are many definitions of political risk. MIGA defines political risk as “the probability of disruption of the operations of MNEs by political forces or events, whether they occur in host countries, home country, or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also of minority groups, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment” (MIGA, 2009, p. 28).

When discussing the reasons why a country needs to set up an ECA, Stephens’ states that “political risks are those relating to the actions of governments in importing countries to prevent payment being made to the foreign exporter, for instance problems with transferring foreign currency. Default by government or public sector buyers or guarantors in another example, as is civil war” (Stephens, 1996).

Beside political risk, commercial risk is also a concern of companies worldwide when they expand their business to emerging markets. The commercial risk is defined by the OECD (in the context of export credits) as “the risk of nonpayment by a non-sovereign or private sector buyer or borrower in his or her domestic currency arising from default, insolvency, and/or a failure to take up goods that have been shipped according to the supply contract” (OECD 2003). And Stephens has a quite similar definition on commercial risk “the principal commercial risks are insolvency of the buyer, default on payment by the buyer and repudiation of or refusal to accept the goods or services ordered” (Stephens, 1996). Commercial risk can be high in emerging markets where the financial system is still immature as compared to developed countries. The lack of financial information and the quality of information in these markets partly institutes the threats of commercial risk. Credit rating agencies and the exporters themselves cannot always assess credit worthiness comprehensively and sufficiently based on the limited financial information of their buyers.

As Nerouppos et. al. emphasized in a study the lack of data in emerging markets can lead to tremendous difficulties for risk management. “Another problem, equally important from a risk management point of view, is that there is a startling scarcity of available data. Often, the institutional mechanisms that lead to the plethora of data in advanced markets do not exist (e.g. derivatives exchanges, secondary markets, and even regular auctions of a standard set of government bonds). Furthermore, those data that are available are contaminated for many reasons. Since many emerging markets have gone through some period of crisis, the history of local financial variables is of questionable value in calibrating mathematical models for assessing future risks. Any current price data that are available must be viewed in light of the volumes and

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1 Malcolm Stephens is Secretary-General of the International Union of Credit and Investment Insurers (Berne Union). He was formerly Chief Executive of the Export Credits Guarantee Department in the United Kingdom.
liquidity of local markets. All of these factors lead to tremendous difficulties for risk management” (Nerouppos et. al., 2006, p. 180–181).

In spite of the high level of risks in emerging markets, companies do not stop tapping into these markets because of potentially high profit margins they can get. In order to mitigate political and commercial risks the use of risk mitigation instruments has become more important for companies exporting to and doing business in emerging markets. These instruments are provided mostly by export credit agencies (ECAs), multilateral financial institutions and private insurers. Most ECAs and multilaterals are members of the Berne Union² (International Union of Credit and Investment Insurers).

According to EKN, the Swedish Export Credit Agency, the volume of guarantees this agency issued increased from more than SEK 20 billion in 2007 to more than SEK 115 billion³ in 2010 (EKN, 2010). This evidence unequivocally illustrates that risk mitigation instruments are in high demand in a country like Sweden and risks in foreign markets need to be managed and reduced. This increased demand enhances the important role of an ECA in exporting or home country. And in a discussion paper Stephens argues that among the many reasons to set up an ECA in a country have to do with confidence to export, protection against risk, improvement in competitive position, access to bank finance, source of information and trade expertise (Stephens, 1996).

The following chapter discusses risk mitigation instruments offered by ECAs and at the same time discusses the preliminary findings from a research conducted by the authors in co-operation with a large Icelandic company, Marel, who is engaged in manufacturing food processing equipment. This company has production facilities in several countries. The objective of this research is to answer the research question How can private companies benefit from the funding and risk mitigation instruments of Export Credit Agencies? The focus is on trade with emerging market economies.

1. Risks mitigation instruments offered by Export Credit Agencies

When private companies engage in cross border trade or investment in emerging markets, the risks they face is a key concern. Not only small and medium sized companies need to evaluate and assess the risks they are faced with carefully, but also large corporations with stronger financial capabilities need to protect properly their business from risks. In order to meet this existing demand the political and commercial risk insurance industry has been formed. The leading association in this industry is the Berne Union (founded 1934) with 73 members including mainly ECAs, multilateral institutions, and private insurers (MIGA, 2010). ECAs are either public-sector ins-

² “The Berne Union (BU) was founded in 1934 in order to promote international acceptance of sound principles in export credit and investment insurance and to exchange information relating to these activities. Today, the BU has 73 members (including Prague Club members) comprising mainly export credit agencies (ECAs), multilaterals and private insurers. The BU plays an important role in bringing together the public and private insurers to enhance cooperation and information sharing. Members meet on a regular basis to discuss industry trends and challenges” (MIGA, 2009).

³ This amount is equivalent to USD 3 billion in 2007 to USD 17 billion in 2010.
tutions in their respective countries, established to provide support for the exports of that country, or private-sector companies that act as a channel for government support for exports from the country concerned (Yescombe, 2002).

In general, these ECAs will charge premium to those companies who use their products. The “OECD country ratings are designed to set guidelines to price the default risk on export credit and to set minimum premium rates charged by participating ECAs” (MIGA, 2010, p. 63). The ratings known as Knaepen Package came into effect in 1999, is a system for assessing country credit risk and classifying countries into eight risk categories, from 0 to 7 (OECD n.d). Basically, ECAs will assess political risk and commercial risk when they issue guarantees to exporters or foreign buyers. ECAs use country ratings by OECD as platform to assess political risk or country risk while commercial risk is assessed based on each individual corporate’s information such as operation and background information, financial and audited annual reports, project feasibility studies, etc. Companies who are eligible to use products or services provided by an ECA must have their operations relevant to national interest of the country where the ECA is located. In other words, the companies must contribute to national economic development of that country in a direct or indirect way. For instance, a company must have production facilities located in the home country of the ECA. The ECA can also support a home company who has production facility in a host country.

There are various products or risk mitigation instruments offered by these ECAs and these products can be the same or very similar from one ECA to another. Products of ECAs include, for example: Bond Guarantee, Investment Guarantee, Project Financing Guarantee, Financing Guarantee, Project Delivery Guarantee, Working Capital Guarantee or Reinsurance. The products that this article focuses on and analyzes are: (i) Buyer Credit Guarantee, (ii) Supplier Credit Guarantees and (iii) Export Loans. Each individual ECA may have different names for their products. For instance Export Credit Guarantee Department (ECGD), i.e. the ECA of UK, names Buyer Credit Guarantee and Supplier Credit Guarantee (the two products of EKF, the Danish ECA) as Buyer Credit Facility and Supplier Credit Financing Facility.

The criteria for selection of ECA also can be various. EKF, the Danish ECA and EKN, the Swedish ECA, do not set any limits to the minimum nor maximum amount of contract value between the exporter and foreign buyer as long as the premium is sufficient to cover for their margin and operational cost, however, ECGD specifies the purchase of good or service worth at least £ 5 million for Buyer Credit Facility or £ 25, 000 for Supplier Credit Financing Facility. The authors chose the three products mentioned above for analysis based on their other relevant research of a large European company in connection to its business expansion in Vietnam. These products seem to be the most suitable in terms of risk mitigation when companies export goods or services to their buyers in emerging markets. However, companies need to find what product suits them best in every specific case.

Buyer Credit Guarantee is basically a guarantee issued by an ECA to a bank that lends money to a foreign importer to pay for an order of goods or services from an exporter in the country where this ECA is located (see figure 1). In emerging econo-
In co-operation with Marel, the authors selected, visited and interviewed 4 of the largest Vietnamese pangasius processors in order to understand their difficulties and constraints in modernizing their processing lines. Export value of these processors on a yearly basis varied from USD 17 million to USD 61.7 million in 2010 (according statistic from VASEP sent via email July 22, 2011). These companies are thus an important source of foreign exchange for Vietnam.

Vietnam Association of Seafood Exporters and Producers (VASEP) is a non-governmental organization, established on June 12th 1998, based on the principles of volunteer, autonomy and equality. VASEP members include leading Vietnamese seafood producers and exporters and companies providing service to the seafood sector.
Buyer Credit Guarantee will help foreign buyers in emerging markets to obtain larger loans from international banks and with longer lending term. This can also be done through a local bank, but it would normally take more time as the ECA is more likely to know the international banks. The bank will then be covered from buyer’s default in repayment due to commercial or non-commercial risks.

Supplier Credit Guarantee is a guarantee issued by an ECA to the supplier or the exporter and this exporter can grant the foreign buyer extended credit on amounts payable for the order. The supplier or the exporter will be protected against the risk of not being paid by the buyer or the importer due to political or commercial risks. The exporter can take advantage of supplier credit guarantee to lend the foreign buyers in an emerging market where an extended credit period may be the key incentive for the buyers to select the most competitive supplier over the others. Supplier Credit Guarantee helps the buyer or the importer repay the order in a longer period (see Figure 2). This can be very advantageous for a buyer who may have limited cash flow and has difficulty in accessing to funds. In a prior research conducted by the authors among 20 largest Vietnamese fisheries processors in August 2011, a set of questionnaire was sent out. All of those who answered indicated that they have to pay the supplier within 3 to 6 months after the equipment has been fully installed and checked. This short term repayment period for the equipment from the supplier is one of their main constraints especially for companies who lack working capital and have difficulty in obtaining loans. The research conducted by the authors in November 2011 found that these companies have not been offered an extended credit period from any supplier. They have to apply for loans from local banks with high interest rates. Most loans lent to them are both short term loans (less than 12 months) and the amount allocated is far lower than the amount they requested. This constraint is one of the reasons why Vietnamese fisheries processors could not purchase sophisticated processing equipment from European manufacturers on a large scale.

They only bought a small part of the equipment needed from these manufactures and the rest of processing lines were locally made or imported from more affordable Asian manufacturers like China, Korea or Japan. This suggests that if buyers from an emerging market like Vietnam are offered an extended credit period, it may affect their investment decision which means that they would perhaps invest more sophisticated processing equipment on a larger scale. Some of the processors in Vietnam have indicated that if they were granted a longer repayment period from the supplier and at reasonable cost they would consider to invest and modernize their processing lines more comprehensively. See figure 2 for the description of how Supplier Credit Guarantee works.

An export loan is a lending scheme to help the exporter’s foreign buyer when this buyer is unable to secure credit facilities from banks for purchasing products and services from the exporter (see Figure 3). In the case of EKF, the Danish Export Credit Agency, they facilitate the export loan through a bank, and the loan is based on the bank’s lending terms. It depends on each individual ECA whether or not they offer the export loan product and how long the lending term will be. But this product is very important in the situation of financial crisis where banks are unable to provide loans to
corporations. The EKF offers export loans as a result of the crisis and application for export loan of EKF can be made until end of 2015. In the same research by the authors in November 2011, the Vietnamese pangasius processors shared the view that local banks can only lend them with the amount not exceeding 20 percent of those banks’ totals lending capital. This reflects the limits in lending capacity of banks in Vietnam. And thus it limits the opportunities for processors in particular and Vietnamese enterprises in a broader view, if they wish to invest intensively. Besides that, each company may enjoy different interest rates depending on how good their relationship is with the lending bank. When this research was conducted, interest rate that these processors had to pay for medium long term loan was 19 percent for VND and 8 percent for USD, these interest rates varies from company to company as explained, however, these rates are considered high, especially the local rates in VND.

Fig. 2. Model of Supplier Credit Guarantee of Danish ECA – EKF

However, the cost associated and premium for this Export Loan scheme is not necessary cheaper than other traditional lending schemes because the export loan is granted jointly by a bank (usually the exporter’s bank) and an ECA to the foreign buyer based on commercial basis and market conditions. Export loan can be even more expensive but it also can be critically important in international trade especially under financial crisis time where most of banks are unable to provide funds to companies. The next chapter will illustrate how this produce is applied with a case in Jordan.
2. How have ECAs instruments been applied? Selected cases

This section demonstrates some success stories of companies who recently used products of the Danish Export Credit Agency, EKF. These cases are quoted directly from cases published on the EKF’s website.

2.1. Olam International Limited and The Use Of Buyer Credit Guarantee from Danish ECA – EKF – for a manufacturing facility in Vietnam (2009)

Olam is a leading global supply chain manager and processor of agricultural products and food ingredients. With direct sourcing and processing in most major producing countries for various products, with the headquarters in Singapore, Olam has built a global leadership position in many businesses, including cocoa, coffee, cashew, sesame, rice, cotton and wood products. Olam operates an integrated supply chain for 20 products in 65 countries, delivering these products to over 11,000 customers worldwide (Olam, 2011).

The challenge
In the year 2009, Olam was looking to invest in equipment for its new coffee manufacturing facility in Vietnam. Olam chose a Danish company namely GEA Process
Engineering A/S as the supplier. Unfortunately, the global economic and financial crisis made it difficult for Olam to secure the financing it needed to buy the equipment. At the same time, Olam’s bank was reluctant to secure long term financing. “Owing to the lack of liquidity in the financial market in February 2009 it would in all probability have been impossible to secure financing with a repayment term beyond 2-3 years for Olam”, – says Antero Ranta from Olam’s bank, ANZ Structured Asset and Export Finance, in Singapore

The process
Thanks to long standing working relations between GEA and EKF, GEA proposed that EKF be involved in the process of procuring financing for Olam’s project in Vietnam. “I was convinced that EKF would be able to assist in putting the financing in place. For our part, it was all plain sailing, as, right from the start, our customer and ANZ were keen to take over and deal with EKF directly”, – says Jesper Duckert, Project Finance Manager, GEA Process Engineering A/S. In order to implement the financing negotiations, EKF decided to send its representatives to Vietnam and had a meeting with representatives from Olam and ANZ Structured Asset. After the visit to Vietnam, EKF had better basis for assessing the actual credit risk entailed by the project.

The solution
After the meeting and negotiation EKF came up with a detailed assessment of the project and was able to offer a buyer credit guarantee. This guarantee meant that EKF assumed a share of the risk of extending a loan to Olam, and therefore, ANZ could secure financing for Olam as they needed. “With an export credit guarantee from EKF we were able to offer Olam a loan with a repayment term of 8.5 years,” says Antero Ranta from ANZ Structured Asset and Export Finance in Singapore. “In spite of the financial crisis we were able to secure long-term financing for our activities on a growth market,” says Arun Sharma, Senior Vice President, Coffee Division, Olam (EKF, 2009a).

2.2. A Jordanian Company namely Modern Cement & Mining Company, and The Use of Export Loan and Buyer Credit Guarantee from Danish ECA – EKF (period of credit: 2010 to 2017)

The challenge
In July 2008 the Jordanian company Modern Cement & Mining Company chose a Danish company namely FLSmidth as an equipment supplier for its new cement plant in the south of Amman. The first deliveries were already paid by the Jordanian company but the main part of the order was to be financed by a local bank. However, due to the global economic and financial crisis, the bank turned down applications for new loans. This threatened the progress of the construction and the order of FLSmidth. FLSmidth decided to contact EKF in the spring of 2009 because FLSmidth had previously been assisted by EKF with guarantees for financing solutions.
The process
EKF had meetings with a number of international and local banks who expressed their interest in taking on the risks of the project provided that EKF would guarantee most of the loans. Furthermore, through the export lending scheme EKF was able to offer a loan to the buyer of FLSmidth services. Then EKF quickly endorsed the project. “EKF’s endorsement was conditional to the approval of the risks and terms in the transaction, its environmental impact and the extent of the Danish economic interest in the transaction – aspects which all needed further examination and subsequent negotiation with the parties involved” (EKF, 2010).

The solution
Finally the solution came into place in May 2010. “Half of the FLSmidth contract was financed with equity from the owners of the cement plant while the other half was financed with loans. More than half of the debt financing came from the Danish export lending scheme administered by EKF, while the remainder was provided by a group of local banks” (EKF 2010). HSBC London arranged the EKF financing. HSBC London is also acting as agent bank on behalf of EKF. Thanks to EKF’s loan and guarantee, the construction of the cement plant in Jordan could continue as planned. And the plant is expected to be ready for production start-up at the beginning of 2012 (EKF, 2010).

2.3. Grain and Seed Exporter Nibulon Company in Ukraine Used EKF’s Buyer Credit Guarantee to Borrow Money from a Western European Bank At a Far Lower Interest Rate Than in Ukraine

The challenge
In 2009, a Danish company, Cimbria Unigrain received the first of two large orders worth EUR 20 million from Nibulon, Ukraine’s largest grain and seed exporter and a high-growth company. This order consisted of eight silo facilities for storing, drying and loading grain and seed. And Nibulon uses this equipment to extend and standardize its storage and transportation facilities by the rivers of Ukraine and the Black Sea. However, the Ukrainian buyer’s constraint was that they had to borrow at a high interest rate in Ukraine to pay Cimbria Unigrain. And this might create uncertainty regarding the order from the Danish manufacturer.

The Process
Cimbria contacted EKF and EKF agreed to assess the viability of the export order and work on the financing options via a guarantee from EKF. “Even allowing for the premium payable to EKF, Nibulon is making a big saving,” says Sales Director Henning Roslev Bukh. He adds that Nibulon regards Cimbria Unigrain and EKF as important and regular business partners.

The solution
Finally EKF offered buyer credit guarantee to Nibulon. This meant that Nibulon was able to secure a loan from a Western European Bank at a far lower interest rate
than in Ukraine. "Nibulon is very pleased that it was possible to arrange a Danish guarantee for this order. We might well have got the order anyway, as Nibulon has ordered from us for many years and is very satisfied with our products. Nibulon could perhaps have financed the purchase with equity, but it is often cheaper to borrow the money than to use equity, and equity is greatly needed in a growth-oriented company such as Nibulon”, – says Henning Roslev Bukh. And in 2010, Nibulon made another order for eight silo facilities – and once again, EKF provided a guarantee for the buyer’s payments. Thanks to this order Cimbria Unigrain has hired 30 employees in 2010 (EKF, 2009b).

2.4. Marel and the possibility of the use of ECAs products in Vietnam

Marel is one of the leading manufactures in food processing equipment. Marel is headquartered in Iceland but has production facilities for processing lines in fish, poultry, and meat in numbers of European countries, USA, Brazil and in Asia. Marel is ambitious to expand their business in emerging markets where food processing industry is becoming more important like for example in China, Thailand and Vietnam. However, the purchasing volume of buyers from these markets remains low especially in Vietnam.

The research in cooperation with Marel, mentioned earlier, among largest pangasius processors in Vietnam, found that Vietnamese buyers bought some limited number of equipment rather than comprehensive processing lines. During in-depth interviews with the 4 largest Vietnamese processors, the authors was told that most of equipment made by European manufacturers is very sophisticated and advanced, however, this equipment is too expensive for them to purchase on a large scale. Instead, they needed to select some equipment which is most important for them. The remaining equipment they bought from more affordable manufacturers from China, Korea or Japan and some other equipment is locally made. When asked, these processors said they were aware of the fact that having advanced equipment in their processing lines would enable them to export more of their products to high income markets like USA, Europe and Japan. The critical issues rest in funding which prevents them from investing intensively. The issues here include low amount of loan allocation from local banks, limited availability and accessibility to long term loans especially in foreign currency like USD, high interest rate, short repayment period to the equipment suppliers etc.

At the same time, the authors interviewed some ECAs in Europe like EKF (Denmark), EKN (Sweden) and ECICS (Singapore); in response to the question what products offered by ECAs they thought are most suitable for Marel and its buyers in Vietnam given the constraints mentioned above, these ECAs thought that two products should be suitable which are Buyer Credit Guarantee and Supplier Credit Guarantee. The recommended products of ECAs could help Marel achieve its goal which is to expand its business in Vietnam. However, the ECAs also said that in order to be supported by ECAs’ instruments the Vietnamese buyers need to fulfill the requirement in terms of being able to provide sufficient and transparent information of their companies, espe-
cially financial information, including audited annual reports. The readiness and well
done “home-work” of Vietnamese buyers will help the process of ECAs in assessing
their creditworthiness and making decision on their request quicker. Most of the Viet-
namese fisheries processors now are working with local banks both state owned and
privately, however, ECAs indicated that if foreign buyers work with international banks
it will normally make the process faster because ECAs have more working experience
with large international banks than local banks in a specific country.

Conclusions

When private sector companies engage in cross border trade and/or investment
they are more likely to face higher risks than in domestic markets. These risks are non-
commercial/political and commercial and the level of risk is different in different mar-
kets. In the context of emerging markets and due to the current uncertainty in financial
market, these risks have moved towards to the top of corporate agendas. Certainly,
these risks should be managed and appropriate risk mitigation sought.

In order to cover the existing demand and to promote the export of its home pro-
ducts, ECAs worldwide provide various risk mitigation instruments. Through the re-
search done by the authors and the real cases described in this article, we can see that
there are real possibilities for companies to have risks covered thus enhance their bu-
usiness development especially when they tap into emerging markets. These instru-
ments are even more important during times of crisis.

Among the key factors to make things happen is the ability of ECAs to assess the
creditworthiness of companies involved especially the foreign buyers. Therefore, in
response to this issue, foreign buyers should provide full and transparent financial
information to help the process move faster, including audited annual reports. Besides
that, ECAs prefer working with international banks that they know and already have a
business relationship with so it would be advantage for foreign buyers to seek loans
from international banks such as: ANZ, HSBC, American Standard Chartered Bank or
international organizations like the Asian Development Bank and the International
Finance Corporation of the World Bank Group, etc. The products offered by ECAs
show that the risks associated with non-commercial/political and commercial risks in
emerging markets can be managed, and the cases discussed in this article are tangible
evidence of recent success during a global economic and financial crisis.

References


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