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Export Credit Agencies in the Capital Markets

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The business environment facing export credit agencies (ECAs) has changed significantly. In the future, overt government sponsorship of national ECAs will likely continue its declining trend. This will provide ECAs with new opportunities to make greater use of the capital markets.

The New Environment for ECAs

In the exporting arena, the globalization of investment and the way firms now source from many countries have made the traditional national orientation of ECAs increasingly difficult to sustain. ECAs are rightly entering into agreements that allow for cooperative financing and reinsurance. The logic of government sponsorship of a national ECA has been undercut. Perhaps a multilateral ECA is not too far off.

In the financing arena, the huge expansion of global commerce has left ECAs with a smaller role in the overall trade picture. ECAs are financing a smaller share of industrial-country imports and transactions that originate with large-scale exporters and global banks. They are also writing a smaller share of short-term insurance cover. The business of providing export credits and export credit insurance has, to an increasing degree, shifted to the private sector.

The big exception to this trend is in the emerging markets. Among developing countries, ECA financing still represents 20 percent of total

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debt, and 50 percent of total debt to the official sector. In the riskiest countries, the share of ECA financing is higher still. But even in the case of ECA financing to emerging markets, global financial markets––and the capital markets in particular—during the past decade have dramatically enlarged their capacity to provide debt finance to these countries. Private financial markets are now able to channel medium- and long-term capital, and assess credit risk (albeit imperfectly), in the very countries where ECAs are doing the bulk of their business.

Curtailing ECA Subsidies

The decline in export credit subsidies dates back to the Organization for Economic Cooperation and Development (OECD) negotiations that were launched in the 1970s. In two decades, these accords have gone far to restrict expensive, and highly distorting, ECA competition. The OECD Arrangement has reined in interest-rate subsidies, tied aid, and, most recently, pricing of risk premiums across a wide diversity of lending, guarantee, and insurance products. Significant further work remains to be done––in particular, on agriculture, on ensuring that market windows do not circumvent the OECD Arrangement, and on making sure that untied aid is genuinely untied. We can expect negotiators to continue their past good work—so that exporters, not ECAs, are the ones that compete for markets.

Perhaps more than anything else, this rooting out of subsidies has contributed to a withdrawal of ECAs from markets where private creditors and insurers are now dominant. In turn, ECAs have concentrated more on emerging-market countries, on the private sector, and on providing medium- and long-term cover in these markets.

Although the OECD Arrangement has limited the overt subsidization of exports, more could be done. For example, the adoption of accrual accounting would force ECAs and governments to estimate contingent claims. This could play an important disciplinary role in further rooting out subsidies. But if the elimination of subsidies is to be complete, the real challenge will be to develop effective systems of assessing and managing risk, particularly as ECAs shift their business to nonsovereign exposures in emerging markets. The capital markets can help in this evolution.

Involving the Capital Markets

We can expect the capital markets to become more engaged in the business of ECAs as these agencies go further to eliminate subsidies from the credit and insurance products they provide. The reason is obvious:

by definition, if ECAs do not subsidize, their fees will be sufficient to provide adequate returns for investors. If ECA fees are inadequate at the outset, private financial markets will only get involved with ECA risks when ECAs are willing to mark down their assets below par, and few ECAs are willing to take this medicine. But if ECA fees are initially adequate, private financial markets will work alongside ECAs in financing exports. Let us briefly look at three opportunities for the capital markets to contribute to the way ECAs acquire and manage their assets.

Pricing Risk

The first opportunity concerns the pricing of products. Although the capital markets are not active in all the countries in which ECAs operate, they are active in those emerging markets where ECA exposures are largest, at least at the sovereign level. Capital-market instruments trade even for some of the largest private companies that are ECA clients. The prices of these instruments can serve as useful benchmarks to the ECAs when pricing their own products, and they should serve as guides for evaluating the OECD agreed-on minimum risk premiums for different countries.

I do not want to exaggerate the accuracy of market prices. Anyone observing the behavior of financial markets in Latin America and Asia during the past 10 years knows that markets are fickle and overshoot. The market at any point in time can be a very imperfect indicator of fundamental risk. But even in volatile emerging-market countries, investors are not blind. Over time, both capital flows and prices do adjust to economic realities. And it is hard to argue that ECAs, with far leaner staffs, and no on-the-ground presence in the countries where they conduct business, can consistently do a better job of analyzing and pricing risk than the private financial markets.

Selling Exposure

The second way that ECAs can use the capital markets is by helping to scale their balance sheets. ECAs are in the business of providing export credit and insurance when markets will not. However, this does not necessarily mean that ECAs need to own the resulting assets. Most credits or insurance exposures that ECAs own can be transferred to the market, freeing up ECA capital—or raising funds for new ECA lending, or enlarging the ECA's guarantee capacity—without having to seek new government appropriations. One example, where JP Morgan & Company was involved, was a transaction by which France liquidated a substantial block of its exposure to Poland. Even credits for which there are no liquid markets can be securitized. In 1999, Italy's Sezione Speciale per l'Assicurazone del Credito all'Esportazione bundled together some 20 illiquid exposures and sold off various tranches of this risk to the markets in a well-received deal.

Managing Risk

A third way in which ECAs can benefit from using the capital markets is through various risk management techniques that are now common practice. For example, many official lenders have foreign exchange exposures that they could hedge through cross-currency asset swaps. Others have a portfolio of fixed-interest-rate exposures that were created when interest rates were higher than today. The economic value of these assets can be unlocked with an interest-rate swap that converts the fixed rates into floating rate instruments.

Credit derivatives may be an even more powerful tool for ECAs that hold highly concentrated country exposures (owing to the very nature of the export credit business). Today's markets for emerging-market sovereign credit default swaps are capable of handling $10-20 million exposures in single transactions, without in any way altering the relationship of an ECA to its customer. JP Morgan now has a Web site that lists swap pricing for literally hundreds of names, including dozens in the emerging markets.

For larger transactions, funded risk management tools—such as credit-linked notes, collateralized loan obligations, or even unfunded portfolio approaches to credit risk management—may be more appropriate. For example, JP Morgan has used its synthetic unfunded portfolio approach to credit derivatives—its "Broad Indexed Secured Trust Offering" structure—to off-load $75 billion in portfolio credit risk from its own books and from the books of its client banks. It did this without actually transferring title to the assets.

My point is that, as ECAs become more market oriented, they can use private capital markets both in the way they originate risks and in the way they manage the risks already held in their portfolios. JP Morgan is now in active dialogue with several ECAs on the use of new instruments.

Will the Capital Markets Transform the ECAs?

Whatever other benefits might ensue, fostering a market in ECA exposures would provide policymakers with a useful management tool to assess whether or not subsidies have in fact been eliminated from the system, and what they are getting for their money when subsidies still exist.

It is not realistic to think that subsidies can be eliminated entirely from ECA operations, or that ECAs will come to fully resemble private financial institutions. Policymakers continue to view ECAs as vital tools of public policy. This can be a good thing. Ex-Im Bank, for example, played a key role in restoring confidence in the aftermath of the Asian financial crisis through its willingness to provide billions of dollars of finance when the private market had dried up. Today, Ex-Im is ramping up its efforts in Africa, in markets where private creditors are generally unwilling to commit, but where the returns may warrant the effort. Beyond overcoming these possible "market failures," I would expect ECAs to continue to fulfill many noneconomic mandates that policymakers give them.

For example, when sovereign ECA exposures are rescheduled in the Paris Club, finance ministries in effect extend the subsidy further by rescheduling credits essentially on the original terms. They do this at a time when markets are either closed completely to the borrower or are charging much higher interest rates. Providing finance in this manner is often vital to relieving a financial crisis. The Indonesian case is the most recent example. But these financial actions amount to a subsidy, in view of the increased risk and generous terms. Finance ministries, however, do not recognize the subsidy, except when debt reduction is part of the package.

ECA activity might bring good social returns to taxpayers, profitable deals for exporters, and stability to world financial markets. But I would be surprised if ECAs do much better than break even in financial terms—defining "breaking even" as just covering government borrowing and administrative costs. Given their policy mandates, ECAs will have a hard time pricing products on purely commercial terms.

So ECAs are in a contradictory position. On the one hand, they are being asked to accept the riskiest exposures–-whether because the exposures are unknown, unproven, or illiquid-–in order to make the export deal possible. ECAs are faced with the problem of adverse selection. If they stick to the role of lender of last resort, they are bound to be left with a portfolio that is either undercompensated or of poor quality. On the other hand, ECAs are supposed to operate at unsubsidized rates—in a world where credit and insurance terms are increasingly benchmarked against financial market alternatives to determine whether a subsidy exists. The capital markets can help ECAs to contain their dilemma, but only governments can resolve it.