



Access to Preshipment Export Finance: Do Guarantees Help?

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Many small- and medium-sized emerging exporters in developing countries have inadequate access to short-term working capital to finance their export transactions. This is mainly due to a market failure resulting from informational asymmetries on the part of banks about exporters' ability to execute export orders according to buyers' standards of quality, cost, and delivery. Several countries have established preshipment export finance guaranty facilities to help alleviate this market failure. Their aim is to act as catalyst to temporarily share nonperformance risks of exporters with the banks, allowing the banks to evaluate nonperformance risks of emerging exporters. Some countries have implemented these facilities successfully encouraging banks to provide preshipment finance without guarantees, while others have not. This note draws on Tunisia's experience to outline the necessary conditions for the success of these facilities.

The Process of Exporting and Export Finance

In financing trade transactions, financial institutions are confronted by at least three types of risks, or perceptions of risk, associated with the pre- and postshipment export financing:

- Nonpayment risk or buyer risk: the risk that the foreign buyer does not pay exporters.
- Nonperformance risk or supplier risk: the risk that the exporter will not fulfill the export order, cannot manufacture the product for technical reasons, or cannot deliver it on time and according to the price and quality standards identified in the export order or the letter of credit (L/C).
- Third party risk: other risks that are involved in the transactions process, such as risks related to transport.

If these risks, or perceptions of risks, are higher relative to the return on lending, financial institutions will not provide financing for export transactions. In response, credit enhancement instruments

have been developed to cover a part of these risks, during both pre- and postshipment stages of export transactions. For example, export credit insurance insures banks against nonpayment risks, while preshipment export finance guarantees (PEFGs) cover a portion of nonperformance risk. Insurance related to transport, fire, and so forth, cover other risks.

Availability of Preshipment Export Finance

Enterprises require preshipment financing to fulfill export orders. This can come from the exporter's own resources, buyer credit or short-term credit from financial institutions. In fact, the bulk of preshipment financing is provided by financial institutions. However, financial institutions may serve preshipment finance needs of large, well-known exporters more easily than emerging and small exporters (ESEs). One reason is that banks in many countries have underinvested in systems and training necessary to adequately appraise nonperformance risks, especially for ESEs. Instead,

A challenge for many small exporters is access to working capital to produce their exports.

Preshipment guarantees have been developed to overcome various challenges.

they mainly favor collateralized lines of credit, which firms use at their discretion. As such, large and well-known exporters can generate preshipment working capital from bank overdraft facilities backed by the exporters' collateral. ESEs, on the other hand, do not have adequate internal resources and they lack access to short-term bank loans or credit because of their high perceived credit risks. Even if these exporters hold a confirmed L/C, banks may still require a pledge of the exporter's assets before they extend the preshipment loan. The reasons behind this market failure are the informational asymmetries on the part of banks about ESEs' ability to execute export orders according to buyers' standards of quality, cost, and delivery (that is, nonperformance). Export credit insurance and guarantees, offered by most export insurance agencies, do not address this market failure. Instead, they protect exporters and banks granting export finance against foreign buyers' nonpayment risks, rather than exporters' nonperformance.

Objectives and Principles of Preshipment Export Finance Guarantees

The objective of PEFGs is to encourage financial institutions to provide preshipment financing to ESEs with viable export contracts whose perceived nonperformance risk is greater than actual risk. The PEFG does this by guaranteeing a portion of short-term preshipment export loans, thus assuming a portion of (perceived) risks, on a temporary basis. As such, it allows financial institutions to evaluate the nonperformance risks of ESEs over time, therefore serving as a catalyst for developing sustainable preshipment financing for ESEs. The PEFG approach is different from other SME guarantee schemes in that it is transaction-based and self-liquidating. PEFG facilities could be established, operated, and administered by a government agency (normally the export credit insurance agencies or Ex-Im banks).

Principles. In addition to an appropriate incentive regime that does not penalize exporters, the following seven principles are key to the success of PEFG schemes:

1. *Assuring simplicity.* PEFGs' designs must be simple so that participation by banks

does not increase ESEs' transaction costs or create too large a burden on ESEs through the guarantee fee charged. The information required from exporters interested in PEFGs should be focused on the export transaction rather than on the detailed asset, liability, and net worth information of the firm.

2. *Maximizing social benefits.* PEFGs should not be thought of as profit-making instruments. Instead, social benefits of PEFG operation must be higher than its social costs. Social benefits are additional export value-added, taxes, and jobs created. Social costs include net defaults (gross defaults minus recoveries), administrative costs, and the opportunity cost of the PEFG fund.
3. *Minimizing moral hazard* (loan misuse). Exporters must self-finance a part of their preshipment export finance needs. Similarly, commercial banks must take a part of the preshipment export finance default risks.
4. *Making PEFGs easily accessible.* ESEs, including indirect exporters, should be able to benefit from PEFGs as long as they possess either of the following: (a) confirmed export L/Cs issued in buying countries with little political risk; (b) export credit insurance coverage for non-L/C-based exports or exports to politically risky countries; or (c) back-to-back domestic L/Cs.
5. *Rapidly disbursing banks in case of default.* The PEFG should cover both perceived and actual risks of exporters' manufacturing nonperformance. When there is default based on nonperformance or bad faith, the PEFG would bear that cost rather than the banks.
6. *Assessing risk, but on an ex post basis.* The PEFG agency would screen out exporters with inadequate production facilities through enterprise visits by guarantee officers and the support of well-developed information networks. It will also screen out on an ex post basis exporters that have loan misuse risks (bad faith). However, the PEFG agency or banks should not attempt to evaluate individual exporters' manufacturing nonperformance risks on an ex ante basis. Accurately evaluating such risks would require significant capabilities and

expertise, which are normally too costly to develop in a PEFG agency.

7. *Establishing credibility, a good reputation, and trust with exporters and banks.* Four conditions must be met to achieve these objectives: (a) a strong and proactive management team with aggressive guarantee officers; (b) availability of sufficient resources to cover claims; (c) clear rules for PEFG coverage and payments, and (d) speedy and transparent processing of guarantee applications and claims based on these rules.

Tunisia's Experience with PEFGs

A \$5 million PEFG facility in Tunisia was established under the World Bank-supported Export Development Project in 2000. Tunisia's experience demonstrates that PEFG performance and success depends critically on the extent to which the above principles are applied. When the principles were strictly applied at the inception of the PEFG facility, the scheme performed well, and subsequently when they were not, it performed poorly.

The facility design was simple. It guaranteed up to 90 percent—with an average of 50 percent—of the nonperformance risks associated with preshipment export loans with maturities of up to 180 days, which were made by participating banks to ESEs. A premium of 0.15 percent per month was paid by the borrowers and was set at this level to ensure that it did not constitute a major financial burden on exporter. The scheme, which was administered by the Export Insurance Agency (COTUNACE), did not cover buyer nonpayment, buyer country risk, maritime disasters, and other risks. The application process for the guarantee was simple and information was required on the export transaction, rather than on the financial position of borrower. Initially, a proactive and skilled management team was put in place to market and operate the facility.

The PEFG facility was expected to generate substantial socioeconomic benefits. The present value of net social benefits during five years was estimated at \$277 million. The key assumption for this estimate was that all PEFG principles would be applied, ensuring that demand for the facility would increase over time and loan defaults would

decline. Increased demand would imply that the guarantee coverage ratio (the ratio of outstanding guarantees to initial fund) would gradually increase from 2 in the first year to 15 in the fifth year. It was further assumed that 100 jobs would be created for each \$1 million of additional exports.

In fact, the performance of the PEFG in Tunisia was mixed (see Table 1). The facility went through two distinct phases:

- *Stellar performance during the first six months.* During the first six months, the facility issued 43 guarantee certificates, exceeding performance targets for the facility for that time period (this represented \$2 million of loans guaranteed and \$3.4 million of additional exports generated). During that time, the management team was strong and proactively led by the chief executive officer (CEO) of COTUNACE. The team regularly visited enterprises and initiated the development of a risk information database on clients. As the head of the Risk Agreement Committee (RAC) of the Ministry of Finance, the CEO of COTUNACE ensured adherence to all of the operational modalities and principles for PEFGs. He also led an extensive marketing campaign and awareness building for banks and enterprises about the availability, objectives, and principles of PEFGs.
- *Sharp decline in performance following initial success.* Subsequently, the facility performed far below expectations. Six months into its operation, the facility's management team was replaced with a less-skilled team consisting of a part time manager with little institutional backing, no business plan, and no clear understanding of and commitment to the PEFG principles. The coverage and outreach of the facility declined and banks lost confidence that the facility to share nonperformance risks. Many banks reverted back to ex ante evaluation of nonperformance risks, which not only delayed the financing process, but also increased administrative costs and substantially reduced outreach to emerging exporters. The lack of proper supervision and follow-up by the PEFG management team even led a few banks to use PEFG as a supplemental guaranty for experienced exporters (one firm used it 28

Guarantees act as catalyst to encourage financial institutions to provide preshipment financing to these exporters.

But the only preshipment guarantee schemes that succeed are those that follow seven key principles.

times, and two others used it 18 times), instead of using it as a catalyst to help new exporters access preshipment finance. A decision by the RAC not to reimburse the banks for two cases of loan defaults due to the bad faith of the borrower also had a negative effect on the credibility of the PEFG scheme. At PEFG closing, out of a total of 57 claims, 27 were rejected, only 19 were fully repaid and 8 were still open.

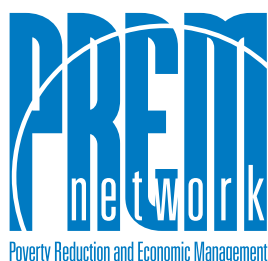
Four lessons could be driven from the Tunisian experience:

1. First, the adherence to the principles outlined above is critical in ensuring success of PEFG facilities. In theory, there are enormous economic benefits from appropriate use of PEFGs, but for these benefits to be realized, all of the PEFG principles must be applied.
2. Second, the success of preshipment export financing schemes requires high levels of management expertise and dedication. Capricious administration can be the downfall of any otherwise sound instrument. A strong and credible management team cultivating good relations with financial institutions is critical for schemes similar to PEFGs that aim to serve as a catalyst to address export financing constraints. Proper promotion and marketing of the scheme is also important, particularly by the banks themselves, which are the ultimate beneficiaries of PEFGs.
3. Third, the PEFG facilities must incorporate mechanisms to reduce the risk of loan misuse, but if there is a loan default due to bad faith of the borrower, the lending bank should be reimbursed by the facility.
4. Finally, the PEFG coverage decisions should be based mainly on the underlying export transaction. Ex ante evaluation of exporters' manufacturing nonperformance risks would delay the process and counter the objectives of PEFGs.

This note was written by Hamid Alavi, Senior Private Sector Development Specialist, Middle East and North Africa Region. It draws on the work of Yung Whee Rhee, who is not responsible for any errors or omissions in this note.

Table 1: Overall Fund Performance: Comparison of Objectives and Results

Performance evaluation		2000	2001	2002	2003	2004
Total amount of guarantee coverage (\$ million)						
	Estimate	5.0	10.0	15.0	20.0	25.0
	Actual	2.1 ^a	2.6	2.0	5.1	3.6
Additional exports generated (\$ million)						
	Estimate	7.4	14.8	22.2	29.6	37.0
	Actual	3.7 ^b	4.1	3.4	10.0	8.2
Annual rate of default						
	Estimate	7.0%	5.0%	4.05	3.0%	2.0%
	Actual	5.7%	24.7%	23.5%	2.5%	5.3%
<i>Source:</i> Tunisia Export Development Project files.						
a. \$1.8 million during the first 6 months of 2000.						
b. \$3.1 million during the first 6 months of 2000.						



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