ADB

Draft Project Concept Note

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PROMOTING TRADE AND INVESTMENT IN CENTRAL AND WEST ASIA: THE CASE FOR A REGIONAL TRADE CREDIT AND INVESTMENT GUARANTEE AGENCY

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Asian Development Bank

DRAFT PROJECT CONCEPT NOTE

A. Introduction

1. The project proposes the establishment of a multilateral trade credit and investment guarantee or re-guarantee agency for Central and West Asia (the "Agency"). The mandate of the Agency would be to foster inter- and intra-regional trade and investment by providing credit and investment insurance and guarantees, as well as other risk mitigation instruments and financial services. Such instruments and services will help increase foreign direct investment (FDI) and improve access to pre-export and trade finance in participating countries in Central and West Asia, including developing member countries (DMCs) of the Asian Development Bank (ADB).

2. Other participants to the Agency may be other trading and investor partner countries, as well as non-state participants, such as multilateral, regional and national development banks, export credit agencies (ECAs), export-import banks (EXIM Banks) and private risk insurers and reinsurers (PRIs). The participation of PRIs provides a platform for public-private partnerships (PPPs), creating mutually beneficial business opportunities through performance based risk sharing arrangements and the leveraging of capital resources.[1]

3. A possible PPP solution would be the establishment of the Agency as a multilateral re-guarantee agency where the private partner would be selected through international competitive bidding to establish, own and operate a private trade credit and investment insurance company acting as the primary underwriter that would automatically cede pre-agreed quota shares of its underwritten risk exposures to the Agency under a long-term risk participation treaty or arrangement. This structure would allow for a far more time-efficient and cost-effective implementation of the project and for the Agency to become fully operational relatively fast.

4. The Central Asia Regional Economic Cooperation (CAREC) program may facilitate the establishment of such Agency.[2] The consideration to establish the Agency is timely with multiple infrastructure investments and other programs in support of inter- and intra-regional trade and investment being implemented under CAREC.[3] The consideration becomes stronger when taking into account adverse impacts since 2008 on GDP growth and trade across the region as noted in the CAREC 2020 Midterm Review which was endorsed in October 2016.[4]

5. In its role of CAREC Secretariat, ADB is well positioned to help: (i) develop the project concept; (ii) structure, establish, and operationalize the Agency; and (iii) engage private risk participation and/or partnerships under a preferred PPP modality. Subject to interest from eligible DMCs, ADB may provide financing support (as needed and subject to relevant internal ADB approvals) for their respective equity participations in the Agency. In addition, ADB may be able to help mobilize financing support from other development partners for similar participations from developing countries outside the ADB membership.

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[1] The establishment of the proposed Agency as a PPP would be in line with one of the five strategic themes laid out in CAREC's first strategy (2006 Comprehensive Action Plan), i.e. developing innovative approaches to cooperative arrangements.

[2] CAREC 2020: A Strategic Framework for the Central Asia regional Cooperation Program 2011-2020 (ADB-2012).

[3] CAREC 2020 (page 5): Mobilizing more resources for CAREC (with an explicit referral to PPPs).

[4] CAREC 2020 Midterm Review: http://www.carecprogram.org/uploads/docs/CAREC-Publications/2016-CAREC-2020-MTR.pdf (English version); http://www.carecprogram.org/uploads/docs/CAREC-Publications/2016-CAREC-2020-MTR-ru.pdf (Russian version).

B. Rationale

(i) The Case for Central and West Asia

6. Most Central and West Asia economies have encountered major challenges in trying to diversify their economies and increase employment through the development of non-traditional sectors, including (relatively more labor-intensive) manufacturing, agribusiness and commercial services. These sectors would necessarily have to be fueled by increased intra- and inter-regional trade and investment opportunities. In this regard, CAREC 2020 cited research results indicating that developing country trade tends to expand faster among countries in the same region than with other countries.[5] While particularly increasing the share of manufactured goods in intra-regional trade, regional integration would help countries compete better globally.[6] Intra-regional trade among the Central and West Asia countries (excluding PRC) has been extremely low at around 6.5% of its average trade volume from 2001-2016 indicating considerable scope for growth. In addition, CAREC 2020 highlights the potential for FDI and joint cross-border ventures, as well as trade in the region as countries gradually improve business integration and product differentiation in markets inside and outside the region.[7]

7. A 2005 publication "*Regional Economic Integration: Case for a Regional Export Credit Agency for Asia*"[8] identified main factors determining an economy's need for support from trade credit institutions:

a. industrialization increases the demand for imported capital goods and engineering services and for the export of manufactured goods, whereby:
   i. buyers of such goods need credit, where the repayment matches the buyers' cash flow generated; and
   ii. buyers in developing countries require deferred payment terms due to paucity of foreign exchange for imports;
b. industrialization has intensified global competition where sellers with competitively priced credit and deferred payment terms have an advantage over those who do not have access to such similar credit and terms; and
c. support of national policies that foster trade and investment.

8. The 2005 publication also noted that ECAs and EXIM Banks have traditionally played a vital role in fostering their countries' international trade. All members of today's Organization for Economic Cooperation and Development (OECD) started establishing their trade credit institutions in the 1920s, whereby exporters and contractors from such countries have substantially benefited from their sovereigns' excellent credit ratings in providing competitive credit terms in their contract bids. With the surge in trade in East, Southeast and South Asia, such institutions have also increasingly become relevant in Asia.[9] However, developing country export credit institutions have traditionally been unable to match the credit terms of agencies domiciled in OECD countries, undermining the international competitiveness of their contractors and exporters.

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[5] United Nations Conference on Trade and Development (UNCTAD), Trade and Development Report, 2007.
[6] CAREC 2020 (page 6): Opportunities for and Strengths of the CAREC Region.
[7] CAREC 2020 (page 8): Implications for the CAREC Program.
[8] Institute of Southeast Asian Studies (in cooperation with the Export-Import Bank of India), 2005.
[9] The 2005 publication interestingly focuses on Southeast, East and South Asia and is silent on Central and West Asia.

9. An internal paper prepared by ADB staff in August 2013 points to the positive correlation between officially supported trade finance and insurance for small and medium enterprises (SMEs) and regional trade growth in Africa and Asia suggesting that access to trade and investment guarantee support significantly improves a country's trade performance.[10]

10. A multilateral trade credit agency can play a critical role in helping the Central and West Asia region diversify their economies. The CAREC region (excluding Mongolia and PRC) has globally become the region with least access to trade credit support. The creation of the African Trade Insurance Agency (ATI)) in 2001 is an interesting example of how a multilateral trade credit agency can boost exports and diversification originating from a less developed region.[11] Since its establishment in 2001, ATI has supported over US$17 billion in trade and investments in the agribusiness, energy, housing, infrastructure manufacturing, mining and telecommunications sectors across Africa. Further details on ATI are explained in Appendix A.

(ii) The advantage of a multilateral agency solution

11. The proposed multilateral agency provides synergies and benefits to all participating countries and businesses (including SMEs) domiciled in these countries. The most important advantage of the proposed agency is to effectively mitigate political risks associated with trade and FDI in the CAREC economies.[12] Additional advantages are operational and cost efficiencies achievable via economies-of-scale coinciding with larger insurable trade and FDI volumes, reduced overheads, risk diversification and sharing, as well as with sharing of knowledge and expertise.

12. A World Bank paper published in 2010 provides a positive conclusion that ECA's in developing countries should be encouraged.[13] However, the paper also acknowledges the challenging low-income country conditions to establish effective national ECAs in terms of economic environment, institutional design, and governance structure. A multilateral agency may have the advantage to better address the challenges associated with the institutional set up and its corporate governance. The consolidation of national ECAs globally, especially in Western Europe since in the 1990s, points to the benefits of multilateral solutions in the context of the globalization of trade. Moreover, the proposed multilateral agency will likely be able to obtain a better credit rating, as has been the case for ATI which has successfully maintained a Standard & Poor's 'A' rating since 2008.

13. Since the 1990s, many Central and West Asian economies placed emphasis on post-Soviet era rehabilitation including the region's transport and energy infrastructure. CAREC 2020 emphasized the importance of reinforcing regional cooperation. Connectivity, is of great strategic importance for the CAREC economies, to facilitate market expansion and respond to the opportunities of: (i) its expanded membership, (ii) the rapidly growing CAREC neighbors, such as countries in the Eurasia (including Russia and Turkey), Middle East and South Asia (including

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[10] Hans-Peter Brunner and Joao Farinha-Fernandes, ADB: "*Link between formal export finance and insurance for SMEs, and regional trade growth in Africa and Asia – Panel data analysis*", 29 August 2013.

[11] ATI is a multilateral ECA supported by the World Bank and the Common Market of Eastern and Southern Africa.

[12] Paragraph 4 of Appendix A below explains how ATI has effectively mitigated political risks due to the World Bank Group's International Development Fund (IDA) having funding the ATI member countries' equity contributions.

[13] Policy Research Working Paper No. 5155: *"Trade Finance in Crisis (Should Developing Countries Establish Export Credit Agencies?)*", World Bank, January 2010.

India); and (iii) growing global trade.[14] The proposed agency would well support CAREC's twin objectives of trade expansion and improving competitiveness including the provision of trade related business services.[15]

(iii) Key product offerings

14. The Agency would offer the following:

a. domestic and export credit insurance covering a supplier's whole turnover business with tenors up to 24 months, thereby:

   (i) improving supplier's competitiveness by providing trade on an open account basis while being protected against buyer non-payment risk;

   (ii) limiting the risk of business forgone due to less favorable credit terms (e.g. cash-in-advance, cash-against-documents, confirmed L/Cs) or potential losses associated with non-performing unprotected open-account trade relationships;

   (iii) increasing access to pre-export financing through import guarantees, discounting or collateralizing of trade receivables that are protected against non-payment, thereby, freeing up working capital and/or avoiding costs associated with alternative means to secure pre-export financing (e.g. debentures, encumbrances and/or collateral); and

   (iv) reducing risk of business discontinuity due to potential nonpayment of unprotected open-account trade receivables;

b. single obligor supplier and buyer credits for infrastructure projects with tenors exceeding 24 months, improving the international competitiveness of member country suppliers, contractors and service providers by facilitating more competitive financing terms; and

c. political risk insurance for inbound and outbound intra- and inter-regional FDI to:

   (i) attract foreign investors to the region;

   (ii) foster intra-regional investments; and

   (iii) protect member country investors for investments made outside the region.

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[14] CAREC 2020 (page 8): Implications for the CAREC Program.
[15] CAREC 2020 (page vii): Executive Summary.

APPENDIX A

AFRICAN TRADE INSURANCE AGENCY[16]

1. **Background**. The African Trade Insurance Agency (ATI) was founded in 2001 by African states to cover the trade and investment risks of companies doing business in Africa. ATI was a World Bank/International Development Agency (IDA) initiative which started in the second half of the 1990s. It provides Political Risk, Surety Bonds, Trade Credit Insurance and Political Violence and Terrorism & Sabotage cover. As of early 2017, ATI has supported over US$17 billion in trade and investments across Africa in sectors such as agribusiness, energy, housing, infrastructure manufacturing, mining and telecommunications. ATI obtained a Standard & Poor's 'A' credit rating in 2008 and has since maintained the same to date.

2. **ATI is structured as a PPP**. ATI is a unique multilateral body that is open to membership by all African and non-African countries, as well as by non-country members. ATI started initially with 7 Sub-Saharan countries (Burundi, Kenya, Malawi, Rwanda, Tanzania, Uganda and Zambia) and expanded its membership with 5 countries (Benin, DRC, Ethiopia, Madagascar and Zimbabwe) and another 4 countries which are in the process of fulfilling their membership requirements (Djibouti, Eritrea, Liberia and Sudan). Allowing membership to all 54 African Union countries under its Treaty, ATI is poised to seek further expansion of its membership in West and Central Africa. ATI also allows for non-African country and non-country members. Atradius Group (Netherlands)[17], COMESA. PTA Bank, SACE (Italy), UK Export Finance (United Kingdom) and ZEP Re are ATI's non-country members at present.

3. **Leveraging ATI's underwriting capacity**. ATI's current 12 member countries have paid-in and/or committed around US$200 million in equity (mostly funded by IDA sovereign loans/grants to its DMCs). The maximum equity contribution for larger economies (e.g. DRC, Kenya, Nigeria, Sudan, etc.) is capped at $25 million and the minimum equity contribution for the smaller economies is $ 7.5 million. While expecting an average contribution of $10 million per country, ATI's authorized capital of $1 billion would allow for further expansion of its membership and reserving a majority share of at least 51% for African country members. A 3:1 internal leverage of US$200 million in capital renders ATI a net underwriting capacity of US$600 million. On a portfolio basis, ATI strives to retain 40% of the underwritten business for its own account by procuring facultative and treaty reinsurance, resulting in a gross underwriting capacity to US$ 1.5 billion.

4. **Effective political risk mitigation through a 'de jure' cross default with IDA**. If an ATI member country were to incur a loss to ATI (i.e. political and sovereign risks), there is a legal obligation for that country to make ATI whole within 60 days after it has paid a valid claim, absent of which ATI would inform IDA (World Bank). IDA, in turn, will then allow the country to cure this situation within another 10 days, absent of which IDA will have the right (not the obligation) to invoke a cross-default and suspend operations in the country.

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[16] http://www.ati-aca.org/index.php?option=com_content&view=article&id=295:zambia-s-banks-challenged-to-innovate-to-increase-lending-to-smes&catid=84:homebanner&Itemid=88#sthash.khr5zUrB.dpuf

[17] Atradius has been a corporate member of ATI since 2001, and it has additionally provided treaty reinsurance on ATI's whole-turnover credit insurance portfolio.