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Export Credit Agencies, Project Finance, and Commercial Risk: Whose Risk is it, Anyway?

Rodney Short*

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Abstract

This Essay questions whether Extra Credit Agencies should provide such long-term commercial risk insurance in project finance transactions. It can be argued that ECA-provided commercial risk insurance in project financings lifts from commercial banks the onus of rigorously analyzing the commercial risks of a project and that ECAs lack the institutional experience and commercial orientation to sufficiently appraise a project's commercial risk. This leads to the very real possibility that projects will be undertaken that on their own (i.e., without commercial risk insurance) might not be commercially viable.

EXPORT CREDIT AGENCIES, PROJECT FINANCE, AND COMMERCIAL RISK: WHOSE RISK IS IT, ANYWAY?

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INTRODUCTION

Export credit agencies ("ECAs"), such as the United States Export Import Bank ("U.S. Ex-Im") and the United Kingdom's Export Credit Guarantee Department ("ECGD"), among many others, have long offered a mix of export support services and products, including buyer and supplier export credits and short to medium term commercial and political export credit insurance. Over time, ECAs have developed a broader array of services as they strive to better complement the services and products of the private sector and as they compete against each other. In recent years, ECAs have begun to offer long-term commercial risk insurance coverage in project finance transactions.

This Essay questions whether ECAs should provide such long-term commercial risk insurance in project finance transactions. It can be argued that ECA-provided commercial risk insurance in project financings lifts from commercial banks the onus of rigorously analyzing the commercial risks of a project and that ECAs lack the institutional experience and commercial orientation to sufficiently appraise a project's commercial risk. This leads to the very real possibility that projects will be undertaken that on their own (i.e., without commercial risk insurance) might not be commercially viable.

I. *ECAs OVERVIEW*

Official ECAs began with ECGD, established in the United Kingdom in 1919, and U.S. Ex-Im, dating back to 1933. In the more than half a century since the end of World War II, a multitude of new ECAs was created as countries around the world

* The author is the Global Head of the WorldWide Projects Group at Clifford Chance Rogers & Wells LLP. He qualified as a solicitor in England and Wales in 1970 and got his MBA at INSEAD in France in 1974. He is currently based in Washington D.C. where he is admitted as a Special Legal Counsel. He has represented both sponsors and lenders over a period of many years in the development of major infrastructure projects around the world.

strove to increase exports.[1] ECAs are subject to international regulation by the Organisation for Economic Co-operation and Development ("OECD") "Arrangement"[2] and the World Trade Organization ("WTO") rules (most notably, requiring that ECAs at least break even), in addition to domestic regulation.

While neither a model nor a precise definition of an ECAs' activities exists, ECAs traditionally promote exports by providing either buyer or supplier credits in support of export/import transactions. In addition, ECAs have long provided short to long-term political risk insurance, short to medium term commercial risk insurance, and comprehensive coverage relating to both commercial and political risks, among other products. ECAs have continually expanded their scope of services and products in an effort to provide better services to their countries' exporters (and to compete with other ECAs). ECAs have begun to offer commercial risk insurance in more complicated and longer-term transactions, which include aircraft/structured finance and project finance.

The ECAs' practice of offering commercial risk insurance (non-payment for commercial reasons) in connection with the financing of major infrastructure projects grew during the mid-1990s. This should be clearly distinguished from the ECAs' long-standing practice of insuring the political risk (expropriation, currency convertibility, and political violence) associated with the export of capital goods to be incorporated in major infrastructure projects (e.g., turbines, boilers, etc.) for a power station. The commercial risk of a project's failure was not traditionally underwritten by ECAs. Policies only covered non-payment contingent upon specified "political" reasons.

International trade and investment is not a zero sum game; gains in trade and exports in one country do not necessitate losses in another country. Nevertheless, there is considerable competition among the various ECAs, as each supports export-

1. The Berne Union (officially, the International Union of Credit and Investment Insurers), which promotes cooperation among ECAs (and private insurers), now boasts 45 members both in and out of the OECD.

2. The Arrangement on Guidelines for Officially Supported Export Credits was entered into in 1978 as a "gentlemen's agreement" among its participants. It has subsequently been incorporated into European Community law. The Arrangement applies to official support for exports of goods and services that have repayment terms of two or more years.

ers from their own country and compete directly with each other. The OECD Arrangement and WTO rules limit, to some extent, the array of services that ECAs may provide, but when one ECA develops a new service or product, the other ECAs will tend to duplicate such innovation so that their countries' exporters will not be at a competitive disadvantage.[3] This competitive dynamic can lead ECAs to search for new products that better service their country's exporters. As an example of this competitive situation, U.S. Ex-Im is required by its charter to submit an annual report to Congress detailing its competitiveness with respect to other ECAs around the world. (In his cover letter to the competition report for 2000, U.S. Ex-Im President and Chairman, James Harmon, remarked, "U.S. exporters are frequently disadvantaged as a result of more flexible and aggressive competitor ECAs' practices and policies"). While this competitive climate pushes ECAs to expand the scope of their activities and the benefits offered to exporters (within the OECD and WTO regulatory framework), ECAs might have pressed too far with regard to project finance and commercial risk insurance.

II. *PROJECT FINANCE, RISK MANAGEMENT, AND INSURANCE*

Risk analysis, as well as the allocation and management of those risks, represent the core of any project finance transaction. Risk is allocated to various contracting parties through the multitude of agreements that comprises a project finance deal, and among other methods of addressing risk, insurance policies of various types allow parties to manage risk allocated to them. Such insurance can generally be divided into two categories: commercial and political.[4]

Political risk insurance comes in different forms but generally covers three principal types of risk: currency convertibility and transfer risk, expropriation and other forms of government intervention, and political violence such as war. Purveyors of "pure" political risk insurance include the United States Over-

3. One stated goal of U.S. Ex-Im, for example, is to "level the playing field" for U.S. exporters, off-setting subsidies or other benefits enjoyed by foreign exporters of competing products.

4. These types of insurance are in addition to "normal" indemnity and civil liability insurance, which this Essay does not discuss.

seas Private Investment Corporation ("OPIC"), the Multilateral Investment Guarantee Agency ("MIGA") of the World Bank, and others, including the private insurance market. As mentioned above, ECAs also have long provided political risk insurance. U.S. Ex-Im, for example, has offered political risk coverage since Congress authorized it to issue insurance and reinsurance in 1961.

Commercial risk insurance covers a variety of commercial risks. Most commonly, such policies will cover the risk of non-payment, delayed payment, or other default of the buyer for certain non-political reasons, including insolvency or other financial inability to pay. Such policies come in a variety of flavors (depending, of course, on the particular provider)—covering short, medium, or long-term risks; single or multiple buyers; and single and repetitive sales—and can take the form of either insurance or guarantees. Coverage also is available for commercial risks involved in foreign direct investment, including equity investment, loans and guarantees, and the acquisition of fixed assets. Rights under such policies are typically assignable (i.e., to banks) so that exporters will be able to obtain more favorable financing terms.

This Essay is concerned particularly with ECAs and commercial risk insurance as they relate to project finance, rather than to short-term export/import trade—the traditional focus of ECAs. ECAs increasingly have become involved in project financings over the past decade as project finance has rapidly gained importance as a favored means of investment in new infrastructure in both the developing and the developed worlds. Indeed, the OECD Arrangement (which establishes regulatory guidelines for ECAs operating in OECD countries) is currently in a three-year test period, during which it is evaluating a policy of flexibility with respect to the dictates of the Arrangement in project finance transactions. In project finance, as compared to general export/import trade, the stakes of transactions tend to be higher and the deals are typically more complicated, longer term, and more sensitive both financially and politically. Also, project financings typically involve a special purpose vehicle whose only asset is the project being promoted and which has no possibility of repaying any borrowings incurred in connection with the construction of the project otherwise than out of revenues generated by the project (or the proceeds of any indemnity insurances taken out in connection therewith). Thus, the OECD and various ECAs have noted that project finance transactions merit different considerations from international trade as such. As a result, the analysis put forth here with respect to project finance transactions cannot be directly applied to commercial risk insurance in non-project finance transactions.

III. *ANALYSIS: IS ECA-PROVIDED COMMERCIAL RISK INSURANCE A GOOD IDEA?*

The purpose of this Essay is to argue that ECA-provided commercial risk insurance may not be a good idea because it may skew the process of commercial risk analysis and may lead to the promotion of projects that do not make good commercial sense. There is nothing inherently bad about commercial risk insurance per se. (Although one can argue that for projects that are genuinely commercially sound it is basically unnecessary, and thus represents inefficient use of limited financial resources—the cost of commercial risk insurance typically ranging from 5% to 8% of the amount insured.) Where the commercial risk assessment and pricing of insurance premia are market-driven, such risk insurance may be an adequate (though inefficient)[5] substitute. A problem arises, however, when the provider of commercial risk insurance is not a genuine market participant. Commercial risk insurance provided by ECAs cannot operate as a substitute for the traditional risk assessment process.

In project finance, the funds provided by lenders provide the wherewithal to promote the project (often in excess of 70% of the capital cost of the project). In a typical project finance transaction, these lenders will conduct a rigorous commercial analysis of the project, testing the commercial viability (the ability and the extent to which the project can generate revenue) of the project under various scenarios. Such lenders operate in a competitive, market environment and will finance only those project companies that demonstrate a reasonable certainty that they can repay the funds they borrow. This analysis serves to vet the good projects from the bad, selecting those that make commercial sense from those that do not. This process leads to the

5. It is inefficient because it should be largely unnecessary for a commercially sound project. At best, the insurance provider will duplicate the analysis that the commercial banks have been providing, increasing fees without any concomitant gain.

good health not only of the lenders but also the various parties to the transaction and, indeed, the economy of the host country. Commercial viability is the foundation of the logic of project finance.[6]

When commercial risk insurance appears on the scene, this situation changes. The lenders will no longer rely solely upon the commercial soundness of the project but will also look to the soundness of the insurance policy. Due to the support offered by the insurance policy, the lenders may overlook shortcomings in the commercial prospects of the project. While the banks will still conduct an analysis of the project, the insurance policy may reduce the rigor required in such analysis where no insurance policy exists. The responsibility for appraising the commercial soundness of the project may pass from the lenders to the insurance provider. But where the insurer does not have a long history of conducting commercial risk analysis, where it is not a fully commercial entity, where its incentives come not from the market but from the government, then the insurer's analysis may not be a reliable substitute.

ECAs have developed an institutional expertise in the area of export credit lending and in some insurance products. They have not done so in the area of long-term commercial risk insurance. While ECAs have played an important role through their traditional export credit services, they have yet to build up the expertise in the kind of complex, long-term commercial risk analysis that is necessary for project finance. One may counter that many ECAs have been involved in offering commercial risk insurance for a number of years (even if only for shorter terms and less complex structures) or that ECAs without sufficient background may simply hire personnel from other institutions that do have such experience. But this lack of expertise is not just a question of training of personnel. Even where ECAs can attract personnel with the "right" experience,[7] the perspective of risk analysts at ECAs will differ from those at commercial banks. As discussed above, ECAs are motivated in their activities by a

6. This Essay does not discuss the motives of multilateral agencies (e.g., IFC, IDB, ADB, etc.) in entering project finance transactions; however, they also provide quasi-political and commercial risk cover, but this is entirely consistent with their developmental objectives.

7. One might question the degree of success that ECAs will have in attracting highly qualified personnel from highly paying positions in commercial banks.

desire to promote exports and (to a lesser extent) a desire to promote foreign policy goals. Their risk analysis, therefore, may be oriented towards promoting these goals, at least in part, rather than making a commercial return on the policies issued[8] (i.e., the risk is that the analysis may be "softer" and more forgiving). Thus the problem can be characterized (and compounded) as a lack of experience coupled with the possibility of a non-commercial orientation towards what pretends to be and ought to be a strictly commercial analysis. The ECAs' analysis can be argued to be an inadequate substitute for that of the commercial banks. The commercial lending market is the best-suited place to distinguish those projects that from a commercial viewpoint, merit financing from those that do not.

The imperfect substitution of the ECAs' commercial risk analysis and insurance for the analysis of commercial lenders can be argued to lead to a poor outcome from the perspectives of both the ECA and the project's host country. It represents a poor outcome for the host country because it distorts many of the benefits that project finance offers to developing countries. Because project finance is "off balance sheet," it provides a method by which developing countries can proceed with infrastructure development programs at a time of limited financial resources. This can be a great boon to the developing country in that such projects (in addition to providing infrastructure needed for development) can be a catalyst for additional foreign and domestic investment; can help to develop ancillary industries; and can help to develop the private sector and, indeed, the free market. But where projects do not make commercial sense, they tend to fail. Where projects fail those benevolent effects just mentioned are reversed. Failed projects discourage future investment, cause follow-on industries to fail, and increase public sector involvement in, and regulation of, the economy, among other detrimental effects.

It also represents a poor outcome for the ECA for several reasons. First, as mentioned above, ECAs operate under the WTO requirement that they at least break even in their activities (to prevent ECA support from operating as a type of concealed trade subsidy). An ECA's exposure in a single project finance transaction may exceed an ECA's total premium income for a

8. Notwithstanding the "no-loss" WTO requirements.

year, and potential losses could imperil the ECA's profitability if its commercial risk analysis is not entirely sound. Second, it is the stated policy of U.S. Ex-Im not to engage in "trade distorting" activities. To the extent that an ECA's commercial risk insurance may promote the export of goods that are "second best" (because the benefit of the insurance policy enables them to beat out superior export goods offered by a competitor in another country backed by a less aggressive ECA), such policies will promote trade distortions.[9] Third, to the extent that the ECA is motivated by the goal of promoting its country's foreign policy, a failed project creates little, if any, goodwill in other countries.

Correspondingly, it is important to acknowledge that this is *not* altogether a bad outcome for the commercial lenders. Commercial lenders desire security in their investments above all else (indeed at a recent infrastructure conference in Frankfurt one speaker complained that it was almost an "article of faith" amongst commercial banks not to accept any risk). If they can obtain that security through a sovereign guarantee over a commercially questionable project, that represents a fully acceptable (or preferable) substitute to reliance on the revenue of a commercially dubious project from the bank's perspective.

IV. *EFFECTS OF SOFT COMMERCIAL VIABILITY*

When commercial risk insurance enables projects to proceed that would not otherwise be commercially viable, it creates several problems. First, to the extent that the benefit acts as a form of foreign assistance, project finance represents a poor method of providing such aid.[10] Project finance deals tend to involve substantial transaction costs. If the risk of commercial

9. An analogy may be drawn between ECAs' support of "tied aid" (trade related aid credit provided by donor governments for public sector projects in developing countries that is conditioned on the purchase of equipment from suppliers in the donor country) and their foray into commercial risk insurance. Just as tied aid may distort a buyer's decision-making process so that it will purchase "second best" materials that come with financing rather than first choice materials without financing, commercial risk insurance can be seen to distort commercial incentives so that projects that would not otherwise be commercially viable will be pursued.

10. Project finance is profoundly different from foreign aid in that project financing is done with "hard money" (i.e., investments that anticipate a market or above-market rate of return) while foreign aid is done with "soft money" (i.e., donor government subsidized aid) and so need not be overly concerned with market pressures.

default is high, perhaps the transaction would be better structured as direct foreign assistance, thus avoiding the added costs involved in setting up the complex contractual web that characterizes project finance. Furthermore, pursuing infrastructure development on a project finance basis means that the host government will retain less control over the project than it would through traditional sovereign lending foreign aid. While this arguably could be seen as a benefit from a free-market perspective, it also means that the project will be tailored toward commercial goals rather than toward any other goals that the host government may have.

Next, where a project finance deal relies on commercial risk insurance to make the project viable, "structural" problems may be created because such insurance is not a direct substitute for commercial viability per se. In the event that the insurer must pay out on a claim, it will expect a certain amount of control (voting rights) over the project in return for its payment and indeed in some cases the "ultimate" taker of the risk demands the right to take the decisions even before paying out on any claim. The financing banks, on the other hand, will want to retain control over the decision-making process and will want to cede little if any of their control to the insurer. This state of affairs will at best lead to inefficiency and slowdown in the decision-making process and at worst to a kind of distortion of the decision-making process, whereby the decisions over the project are no longer made on a strictly commercial basis.

V. *SUGGESTIONS*

While this Essay has argued that ECAs should not provide commercial risk insurance, it is left to suggest what can be done about this situation. Given the ECAs' attempt to create a "level playing field" for their countries' exporters, no single ECA can be expected (no matter how sound the reasoning) to cease providing commercial risk insurance for project finance transactions unless all of the other ECAs do so as well. There exists a type of "prisoners' dilemma": because there exists competition between ECAs, with each promoting the products of its home exporters, it will be exceedingly difficult to convince one ECA to stop providing commercial risk insurance while it believes that other ECAs will continue to do so.

If ECAs are to withdraw from this line of business, it must be done simultaneously. For this reason, we cannot expect domestic regulators to provide a solution. Instead, we could look to the OECD and the WTO, as applicable. As mentioned previously, the OECD Arrangement regulates ECAs activities. Collective change could be introduced through a change in the provisions of the Arrangement that require all ECAs offering commercial risk insurance in project finance transactions to stop at once, and thus avoiding competitive concerns between the ECAs. To capture those ECAs not subject to the OECD Arrangement, similar provisions would need to be introduced through the WTO.

A possible alternative to banning the extension by ECAs of commercial risk insurance in project finance transactions may be a form of co-operation between ECAs and commercial risk insurers. The commercial risk insurers analyze the commercial risks involved in a project and, if acceptable, join with the ECA in providing a comprehensive insurance package. The ECAs cover the political risk and the commercial insurers cover the purely commercial risks.[11] Through such cooperation, ECAs would avoid the need to conduct their own commercial risk analysis, and the sponsors of commercially viable projects would enjoy (market based) commercial risk cover for those risks that they feel they cannot accept. This solution nevertheless may still be argued as inefficient, including as it does the payment of significant commercial risk premia, which, if the project were commercially viable in its own right, would be avoided.

CONCLUSION

This Essay has argued that ECAs' expansion of their commercial risk insurance products into the realm of project finance, coupled with the different commercial orientation of ECAs, may in some circumstances lead to the pursuit of projects that are not commercially viable. No amount of improvement of their skills in analyzing commercial risk will avoid the charge

11. This is not without precedent. For example, U.S. Ex-Im has in the past cooperated with private insurers and reinsurers through the Foreign Credit Insurance Agency. U.S. Ex-Im combined its services with private insurers to offer comprehensive insurance packages in which it (U.S. Ex-Im) offered political risk insurance while the private insurers offered commercial risk insurance.

that such analysis of ECAs, each of which is prepared to go the extra mile to promote the export of goods and services from its country, represents a "skewed" commercial perspective. This may lead to the approval of projects that are not (without such insurance) commercially viable, and that may, in turn, lead to poor results for both the ECA and the host country. This Essay suggests, therefore, that ECAs should either cease to provide such commercial risk insurance (or be prohibited through appropriate regulation), or should do so only in cooperation with private insurers (who would conduct the commercial risk analysis). By doing so, we would help to ensure one of the most basic principles of project finance—commercial viability.