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Expanding Exports

Role and Relevance of Export Finance

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ABBREVIATIONS

ADB	Asian Development Bank
CBSL	Central Bank of Sri Lanka
CGMSE	Credit Guarantee Fund for Micro and Small Medium Enterprises
CRIB	Credit Information Bureau (CRIB)
DCs	Documentary Credits
ECA	Export Credit Agencies
EDB	Export Development Board
EFIC	Export Finance and Insurance Corporation
EPA	Export Promotion Agencies
EWC	Export Working Capital
EXIM	Export Import
GDP	Gross Domestic Production
GTFP	Global Trade Finance Program
IFC	International Finance Corporation
IFIs	International Financial Institutes
JBIC	Japan Bank for International Corporation
LCs	Letters of Credit
MSME	Micro, Small and Medium Enterprises
NDB	National Development Bank
NEXI	Nippon Export and Investment Insurance
NGO	Non-Government Agency
OECD	Organisation for Economic Co-operation and Development
SCF	Supply Chain Financing
SLECIC	Sri Lanka Export Credit Insurance Cooperation
SLTB	Sri Lanka Tea Board
SME	Small and Medium Enterprises
STR	Secured Transaction Registry
TFP	Trade Finance Program
VCF	Value Chain Financing
WTO	World Trade Organisation

Executive Summary

Since the turn of the century, Sri Lankan exports have declined as a share of its GDP, as well as in terms of its global share. Sri Lanka had a larger global share of exports at Independence, than it does at present. In the past, Verité Research has identified and discussed two corollary indicators as denoting the problem: first, the narrow product range of Sri Lankan exports (over 50% of exports are in just two products), and second the paucity of markets to which Sri Lanka exports (over 50% of exports are absorbed by just two markets). The present study expands its scope to identify a key set of enabling policies that can help Sri Lanka overcome these constraints. These policies can be summarised under the rubric of Export Finance.

Export Finance encompasses a range of instruments that can help promote exports to new markets as well as help diversify the product portfolio of Sri Lankan exports. However, the relevance and applicability of Export Finance for Sri Lanka has not received sufficient attention in the policy making framework.

This paper seeks to partially fill that gap by providing an analytical understanding of how Export Financing instruments can be intentionally developed as a tool to facilitate and promote Sri Lankan exports. It identifies the bottlenecks that prevent the effective use of Export Finance in Sri Lanka and provides recommendations to improve availability, access and the effective utilisation of Export Finance instruments in the country.

Understanding Export Finance and its Benefits

Export Finance focuses on providing payment, financing and risk mitigation solutions in support of the transactions between Sri Lankan exporters and foreign buyers. Export Finance can play an important role in addressing some of the key challenges faced by Sri Lanka in the export sector. Ability to offer payment terms more favourable to buyers enhances the chances of exporters securing more orders. Export Finance instruments enable exporters to offer competitive payment terms to buyers whilst mitigating the default risks and working capital shortages that arise from such competitive payment terms.

Export Finance is also used to strategically increase Small and Medium Enterprise (SME) participation in international trade. Cost and access to finance are factors that especially undermine the export capability of SMEs. Improving access to Export Finance at reasonable cost could be a critical factor in increasing SME participation in the Sri Lankan export sector.

A key issue in diversifying products and accessing new markets is the shift to new buyers and developing country markets. First involves accepting higher commercial risk and the second involves accepting higher country risk. By mitigating these risks Export-Finance can incentivise Sri Lankan businesses to diversify from developed country markets to emerging developing country markets, to invest in new products and cultivate new buyers.

Typically, the private sector provides Export Finance, but the government has an important part to play in facilitating said provision. Instruments of Export Finance can be provided by private banks and financial institutes specialising in trade financing, acting on their own or on behalf of the government. International financial institutes such as multilateral development banks (e.g. World Bank, Asian Development Bank) also provide risk mitigation solutions to support international trade.

The new Export Finance solutions discussed in this paper vary from traditional instruments such as letters of credit (LCs) and export credit guarantees/insurance to new instruments, such as supply chain financing (SCF), striving to meet new risks and challenges that exporters face with the changing dynamics in the patterns of global trade and transactions.

Limitations of Export Finance in Sri Lanka

Export Finance instruments in Sri Lanka are under-developed. The availability as well as utilisation of Export Finance is low. For example, percentage of export transactions covered by export credit guarantee/insurance is around 2-4% in Sri Lanka compared to the international average of 10-12%. In Sri Lanka critical supply and demand side constraints prevent Export Finance from playing a more proactive role in facilitating and promoting exports. The supply side constraints are institutional deficiencies and the limited portfolio of Export Finance instruments available in the market. The demand side constraints are the low risk and static export structure of the country. Information gaps and asymmetries are constraints that affect both the demand for and supply of Export Finance in the country.

Sri Lanka's Export Finance sector suffers from two types of information asymmetries; first is lack of foreign buyers and market information and second is lack of awareness among exporters about Export Finance instruments and its benefits. Difficulty and high cost of accessing information from Sri Lanka about foreign markets and buyers tend to result in the level of risk being overestimated and therefore over-priced. This is particularly the case with institutions where the risk assessors have limited international experience. Further the low level of awareness about Export Finance result in low demand and use of even the available export financing instruments.

Sri Lanka has a number of institutes that can facilitate and promote the use of Export Finance. These include the Sri Lanka Export Credit Insurance Cooperation (SLECIC), the Export Development Board (EDB) and the Credit Information Bureau (CRIB). The role these institutions play at present in facilitating and promoting Export Finance is limited. This is partly due to the low level of policy focus, weak government support and lack of initiative to facilitate Export Finance. Furthermore, these institutions face limitations in terms of skills, capacity and expertise on the subject.

The low understanding and demand for Export Finance in the country is partly the result of the low risk and static export structure of the country. Export revenue is heavily dependent on few traditional exporters, products, markets and buyers with long standing relationships; along with the low level of understanding the supply has also failed to respond to the emerging needs of non-traditional exports and smaller exporters. The variety, availability and sophistication of Export Finance solutions available in the market are quite limited. Examples of Export Finance solutions that are not offered at present are export factoring, buyer credit and bilateral export credit lines. While there is some availability of Export Finance instruments such as value chain financing (VCF), export credit and payment default guarantee schemes, understanding of their applications and adoption is weak and they remain underutilised.

Practical interventions to improve Export Finance

This study recommends four interventions towards developing a dynamic and sophisticated Export Finance market in the country. It offers recommendations to simultaneously address both the demand and the supply constraints. In broad terms the solutions involve (1) introducing new and innovative Export Finance solutions; (2) improving access to reliable and updated information; (3) improving professional capacity, and credibility of the institutions; and (4) setting up an 'Export-Import bank'.

Export Finance instruments enable exporters to offer competitive payment terms to buyers whilst mitigating the default risks and working capital shortages that arise from such competitive payment terms.

Introducing new and innovative Export Finance solutions

The study recommends introducing new and innovative Export Finance solutions in order to increase capacity and competitiveness of exports (e.g. value chain financing), to increase the cash-flow liquidity of exporters (e.g. export credit refinancing), incentivise access to new markets (e.g. bilateral credit lines) and developing innovative and tailor made financing facilities to increase participation of SMEs and domestic market oriented companies in exports.

Improving access to updated and reliable information at lower cost

The study suggests several types of interventions that relevant institutions can make to improve availability of information. SLECIC as well as other Export Promotion Agencies (EPAs) like Export Development Board (EDB) can play a significant role in improving availability of information to exporters and financial institutes to better assess and mitigate risks.

EDB, for example, can liaise with commercial sections of the Sri Lankan embassies abroad to compile and make available market and buyer information and product export opportunities that are constantly updated. Sector specific institutes that have specialised knowledge in their respective sectors can help design special Export Finance packages (e.g. VCF) tailor made to meet the needs of specific sectors. Organisations like CRIB can link up with credit information providers in other countries to provide information on foreign buyers. Further, government backed organisations like EDB as well as sector specific EPAs can play an active role in creating awareness amongst the SME sector on Export Finance, and even facilitate training to enhance the financial and technical competence of SMEs.

Improving capacity, efficiency and credibility of institutions

The key weaknesses in the institutions established to facilitate Export Finance and promote exports in Sri Lanka include; first, limitations in skills, resources and expertise on the subject and second, the low level of policy focus, government support and initiative to facilitate Export Finance. The study recommends that the government take a proactive role in helping build capacity and encouraging institutions to play a proactive role in facilitating Export Finance.

Setting up an Export-Import bank in Sri Lanka

Specialised export credit agencies play a critical role in emerging markets in promoting trade, particularly facilitating SME participation in international trade. The study finds several gaps in the Export Finance market in Sri Lanka that highlight the need for an Export–Import (EXIM) Bank. For example, although the SLECIC Act envisages that the organisation provide a wide spectrum of export credit facilities and services, the research finds that the services and facilities offered by the organisation are quite limited. Further, although the banking sector provides Export Finance, they mainly cater to large established exporters and mainly facilitate trade with developed countries where the risk is relatively low. An EXIM bank can help address these gaps by offering innovative Export Finance solutions and services tailor made to SMEs, incentivising bank lending at competitive rates to exporters venturing into developing country markets by taking over risks that the private banks are unwilling to take, addressing asymmetries and gaps in information and expanding training and capacity building opportunities for exporters.

Introduction

33 - 15 percent

Decline in share of exports to GDP in Sri Lanka (2000-2014)

0.08 - 0.05 percent

Decline in share of world exports (2000-2014)

Sri Lanka's exports have not kept pace with local and global developments. During 2000-2014, the share of exports to GDP has steadily declined from 33% to 15% and the share of world exports declined from 0.08% to 0.05%. The country's export revenue depends heavily on few products for which the comparative advantage of the country is declining and few markets where growth in demand for imports has been stagnating for a considerable time period. The country also depends heavily on few exporters to bring in most of the export revenue.

Whilst many initiatives have been proposed to address the constraints faced by the export sector, there has been little attention paid to the role Export Finance can play in aiding and promoting exports. Export Finance focuses on providing payment, financing and risk mitigation solutions in support of transactions between exporter and the foreign buyer. Export Finance solutions enable exporters to offer competitive payment terms to buyers whilst mitigating the risks arising from such payment such as buyer default risk, country specific commercial, economic and political risks. Further Export Finance solutions have been widely used strategically by governments to facilitate greater participation by SMEs in international trade and to encourage exporters to export new products, find new buyers and access new markets.

This report analyses the importance of Export Finance as a tool to promote exports and the current bottlenecks that prevent the effective use of Export Finance in Sri Lanka. The report provides recommendations to improve availability, access and effective utilisation of Export Finance in the country.

The report is structured as follows. Section two of the report provides a detailed overview of Export Finance and how it can facilitate and promote exports. Section three outlines the current status of Export Finance market in Sri Lanka and the key issues that hinder effective utilisation of Export Finance in the country. Section four of the report outlines the way forward. This section recommends interventions that can help address the key problems that led to the lacklustre performance of Export Finance market in the country.

Understanding Export Finance & its Benefits

Export Finance is an insurance, guarantee or financing arrangement which enables the exporter to agree to defer payment over a period of time. It facilitates international payments, help mitigate risks, meet export working capital requirements and help build capacity, competitiveness and expand markets. Export Finance can play an important role in addressing key problems faced by the export sector; it can help secure export orders by enabling exporters to offer competitive payment terms to buyers, it can facilitate increased participation of Small and Medium Enterprises (SMEs) in international trade and incentivise exporters to diversify into developing country markets.

The key areas covered in this section are:

- Key functions of Export Finance
  - Facilitate international payments
  - Mitigate commercial and country risks
  - Improve access to export working capital requirements
  - Help build capacity and expand markets
- Export Finance providers
- Export Finance solutions
- Role of Export Finance in addressing Sri Lanka's export problems
  - Help secure export orders
  - Facilitate SME participation in exports
  - Facilitate access to new markets

Key Functions of Export Finance

In the competitive conditions of global trade buyers are increasingly demanding payment terms more favourable to them. From the buyers' perspective, any payment made to an exporter in advance of receiving the goods is a payment made too soon. Therefore, buyers prefer to delay the payment as much as possible. Thus, ability to agree to terms that are more favourable to the buyer has become an important factor that determines the probability of an exporter securing orders. However, by agreeing to defer payments, the exporter incurs considerable degree of credit and payment risk. Export Finance is an insurance, guarantee or financing arrangement, which enables the exporter to agree to defer payment over a period of time. It facilitates international payments, helps mitigate risk, meet export working capital requirements and help build capacity, competitiveness and expand markets.

Facilitate international payments

Export Finance facilitates international transactions by offering various payment options for exporters. The payment options agreed between the buyer and the exporter determine the distribution of risk between the two parties (refer Figure 1). Although there is limited involvement of financial intermediaries in transactions carried out over open accounts, the other types of payment methods are facilitated through financial intermediaries.

Mitigate commercial and country risks

Export Finance instruments help mitigate the risks exporters incur when engaging in international trade. The main risks involved are commercial risk and country risk. Commercial risk refers to risk of non-payment by a private-sector buyer or borrower arising from default, insolvency or failure to take delivery of goods that have been shipped according to the export order. Country risk is the risk of borrower/importer country government actions that prevent or delay the repayment of export credits (e.g., foreign exchange restrictions, sometimes referred to as "transfer risk") and other borrower country risks (e.g., civil war, physical disaster, etc.).

In addition, there are other macro risks; transport and logistics related risks, foreign exchange risk and bank risk. The ability of a buyer to honour payment commitments in time is affected by these risks as well. Transport and logistics risk refers to possible damages and delays that can occur in transporting goods from the source to the destination country. Foreign exchange risks refer to risks associated with exchange rate fluctuations that occur as a result of political, economic developments as well as pure speculation. Bank risks arise due to banks across the world having varying levels of stability and capacity, which in turn affects their performance and credibility. Export Finance plays a key role in assisting exporters to manage these risks. For example, export credit insurance provides protection against such risks and resulting losses.

Improve access to export working capital requirements

In today's world, increasingly buyers determine the payment terms and conditions of the transaction. This means, in order to secure export orders, the exporters are compelled to accept terms and conditions that are more favourable to buyers such as offering longer credit periods and trading on open accounts. World trade finance is shifting from the traditional and more secure payment methods of Letters of Credits (LCs) and Documentary Credits (DCs) to open accounts.[1] When the payments for exported goods get delayed, this creates short term cash flow bottlenecks for exporters

Figure 1: Risk in payment/settlement options

Lowest — **Risk to buyer** — Highest

Open Account	Documentary Collection	Documentary Credit	Confirmed Documentary Credit	Payment in advance
• Remmitance of funds to exporter on delivery or on a future date	• Documents exchanged against payment or acceptance, cursory examination of documents, no verification	• Most secure and balanced option, detailed verificaiton of documents, full compliance with L/C terms	• Documentary credit with added security for the exporter, payment undertaking by confirming bank	• Importer pays exporter prior to shipment of goods

Highest — **Risk to exporter** — Lowest

Source: Improving the SMEs access to trade finance in OIC countries, COMCEC coordination office (2013), page 7and 8 (especially SMEs) that lack sufficient internal liquidity. As a result, they need export working capital financing to purchase raw materials and services required to fulfil export orders. Export working capital financing helps exporters access credit while waiting for payment from the foreign buyer. This helps to ease and stabilise the exporters' cash flow problems.

Help build capacity and expand markets

Exporters (especially SMEs) need financing to support capacity building; for example to meet new importing country standards, upgrade technology and skills, product development etc. Further, they also need financing to participate at trade fairs, find new buyers, access new markets, register/defend trademarks and promote their brand in foreign markets. Credit lines targeting exporters and export markets introduced by financial institutions (in most instances with government support/guarantees) help facilitate these financing needs.

Export Finance Providers

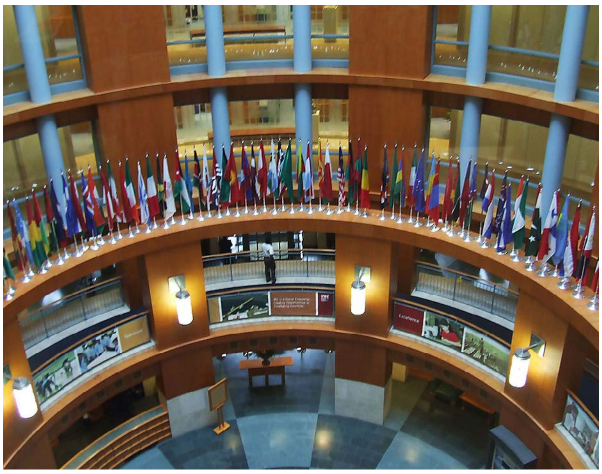
Export Finance is facilitated by two principal providers; private sector banks and financial institutes specialising in trade financing (Export Credit Agencies), acting independently or on behalf of the government. In addition to the domestic financial institutions, International Financial Institutions (IFIs) such as the World Bank (WB) and Asian Development Bank (ADB) also provide risk mitigating solutions to assist international trade.

According to research done by the World Trade Organisation (WTO), private sector institutions tend to focus more on providing short term (up to one year) Export Finance and on financing exports to lower risk high-income and more advanced economy markets. This is partly due to difficulties they face in assessing commercial and country risks. In contrast to private banks, Export Credit Agencies (ECAs) that are fully or partially supported by the government, established to facilitate and promote exports, tend to provide wider coverage in terms of markets and offer short, medium and long term financing options and generally have special financing facilities to support exports by SMEs. ECAs in general operate on commercial terms, especially in areas where they are in competition with private financial institutions. However, it is common to find ECAs providing financing and insurance to exports, on a "break even" basis, with the overall objective of promoting exports of the country.

Risk mitigation solutions in support of trade are also provided by international agencies such as multilateral development banks. The reputations of local financial institutions may not be particularly well established in international markets, and as such, international banks offering trade finance may not be sufficiently comfortable dealing with these local institutions, and may have less confidence in the trade finance solutions issued by local banks in developing markets. In such cases, IFIs conduct appropriate due diligence on local financial institutions, and offer to guarantee the obligations and undertakings of these banks, as one way of mitigating the concerns of international institutions in dealing with local banks. As an example, the World Bank/IFC's Global Trade Finance Program (GTFP) aims to help increase the availability of trade finance in underserved markets by guaranteeing the payment obligation of a local bank in a developing country to an international confirming bank. The program is intended to support liquidity when and where it was needed, assist local banks develop relationships with international counterparts, and enhance trade finance capabilities among local banks.

ADB is a regional IFI that provides trade finance to fill market gaps by providing guarantees and loans to banks in order to assist trade. ADB's trade finance program (TFP) works with over 200 partner banks to provide companies with the financial support they need to engage in import and export activities in Asia's most challenging markets. A substantial portion of TFP's portfolio supports small and medium-sized enterprises (SMEs), and many transactions occur either intra-regionally or between ADB's developing member countries.

Export Finance is facilitated by two principal providers; private sector banks and financial institutes specialising in trade financing (Export Credit Agencies), acting independently or on behalf of the government.



Export Finance Solutions

The types of Export Finance solutions, the availability and the utilisation vary from country to country. Furthermore, with the changing dynamics in the global trading and payment patterns, new Export Finance solutions are being introduced by financial institutes to meet new risks and challenges faced by exporters. A good example is the global supply chain financing that is being offered to facilitate financing needs of companies with internationalised supply chains where production is fragmented to small components and tasks across several countries. Given below is a summary of some of the main Export Finance solutions used to facilitate exports.

Table 1: Different types of Export Finance Solutions

Solution	Use/Benefit
Letter of Credit (LC) or Documentary Credit An LC is a commitment by a bank on behalf of the buyer that payment will be made to the exporter provided that the terms and conditions have been met, as verified through the presentation of all required documents.	▪ Most secure instrument available to facilitate payments ▪ Mitigate default risk for both the buyer and the exporter
Documentary Collections (DC) A documentary collection is a transaction whereby the exporter entrusts the collection of a payment to the remitting bank (exporter's bank), which sends documents to a collecting bank (importer's bank), along with instructions for payment. Funds are received from the importer and remitted to the exporter through the banks involved in the collection in exchange for those documents.	▪ Facilitate payments but limited recourse in the event of non-payment ▪ Less expensive in terms bank charges compared to LCs
Export Working Capital (EWC) Financing Facilitates financing to meet working capital requirements covering the cash cycle from purchase of raw materials up to collection of the sales proceeds. **Pre-shipment Finance** The bank finances the manufacture or purchase of goods to be shipped. Although traditionally based on the seller having a LC that covers payment of goods, Purchase Orders are gaining acceptance as the basis for this type of finance. **Shipment Finance** The bank provides financing from the time LC documents are presented or from when the Outward Collection instructions are received from the exporter until payment is received. **Post-shipment Finance** If the LC or DC specifies time of payment by Banker's Acceptance (BA), Deferred Payment (D/P) or trade acceptance, the bank can extend financing until the maturity date of these solutions is reached.	▪ Facilitate export working capital requirements ▪ Help ease cash flow bottlenecks ▪ Enables exporter to offer more competitive payment terms to buyers ▪ With an LC or Export order the cost of credit is lower than an overdraft ▪ The ability to select a different financial service at any given point in the export process gives a variety of choices to the exporter.

Government Guaranteed EWC Financing

Government guarantee enables exporters to obtain needed facilities from commercial lenders when financing is otherwise not available or when their borrowing capacity needs to be increased. Further, it will help them get financing at more competitive rates.

Use/Benefit

In addition to the above, it will help:

- Improve access to finance
- Reduce cost of finance (specially for SMEs)

Purchase Order Financing

A short-term funding technique used to finance the purchase or manufacture of goods that have been presold to a creditworthy customer. Lenders that offer this specialised form of financing will assist in the purchase of product inventory by using the inventory and confirmed purchase orders as collateral. Purchase Order Financing is a risky form of funding and therefore costs more than traditional financing. It requires extensive due diligence, and lenders are highly selective.

Use/Benefit

In addition to the above, it will help:

- Support working capital costs
- Would not need to wait till the goods/ services are delivered for funds to be available

Export Credit Insurance

Export credit insurance provides protection against commercial losses—default, insolvency, bankruptcy, and political losses—war, nationalisation, currency inconvertibility, etc.

Use/Benefit

- Helps mitigate risks involved
- Provides security for banks offering EWC and financing exports.
- Enables exporters to offer more competitive payment terms to buyers

Guarantees

A guarantee is a type of protection that one party in a transaction can impose on another in the event that the second party does not perform according to predefined specifications. In such an event, the first party will receive a predefined amount of compensation by the guarantor, which the second party will be required to repay.

Use/Benefit

- Helps mitigate risk of non-compliance by a contract party
- Provides a security against default risk

Export Factoring

Factoring in international trade is the discounting of a short-term receivable (up to 180 days). The exporter transfers title to its short-term foreign accounts receivable to a factoring house for cash at a discount from the face value (mainly used for consumer goods).

Use/Benefit

- Helps mitigate default risk
- Ability to mitigate cash flow bottlenecks
- Enables exporters to offer more competitive payment terms to buyers

Forfaiting Forfaiting is a method of trade financing that allows the exporter to sell his medium-term receivables (180 days to 7 years) to the forfaiter at a discount, in exchange for cash. With this method, the forfaiter assumes all the risks, (mainly used in capital goods/ large projects).	Use/Benefit	▪ In addition to the benefits of factoring, forfaiting allows receivables with longer maturity dates to be liquefied.
Government Assisted Foreign Buyer Financing Exporting a country's export credit agency providing direct loans or guaranteeing commercial loans to creditworthy foreign buyers for purchases of exporting country's goods and services (especially useful in providing project financing/high value export financing for emerging/developing country markets).	Use/Benefit	▪ Helps turn business opportunities, especially in emerging markets, into real transactions ▪ Enables creditworthy foreign buyers to obtain loans needed for purchases exporting country goods and services.
Value Chain Financing (VCF) Providing finance to support value-adding activities in a supply chain (e.g. quality, technology, skills upgrading) – from production to consumption, through processing and commercialisation. Includes all value chain stakeholders with a goal of getting product(s) to market (s). (Commonly used to support agricultural exports).	Use/Benefit	▪ Reduces credit risk by integration into a secure market chain ▪ Improves access to financing by SMEs ▪ Helps improve export competitiveness
Supply Chain Financing (SCF) The overall goal of SCF is to optimise working capital throughout the end-to-end of ***globally fragmented supply chain*** for both buyers and sellers. It is a combination of trade financing provided by a financial institution, a third-party vendor, or a corporation itself, and a technology platform that unites trading partners and financial institutions electronically and provides the financing triggers based on the occurrence of one or several supply chain events.	Use/Benefit	▪ Helps the buyer optimize the supply chain by offering bank-assisted open account processing ▪ Meets the seller's Export Finance needs for pre-shipment, shipment and post shipment financing ▪ Provides liquidity to sellers through receivables financing
Payment Default Guarantee Scheme Provides guaranteed payment to exporters if the buyer defaults.	Use/ Benefit	▪ Increases exporters willingness to export to new markets
Bilateral Export Credit Lines A credit line offered by the exporting country (e.g. through an EXIM bank) to the importing country, increasing the ability of the buyers in that country to source financing at competitive rates to purchase goods from the country that is extending credit.	Use/Benefit	▪ Lowers export credit interest rates ▪ Can be customised to increase lending to specific sectors ▪ Encourages the finance industry to lend to specific sectors ▪ Can indirectly reduce the country's average interest rates

Buyer's Credit

Financing extended to the buyer by domestic financial institutions usually supported by the exporters' government.

Bilateral credit lines offered by exporting country government to importing country financial institutions are a form of buyer's credit.

Use/Benefit

- Reduces payment default risk to exporter
- Reduces short term cash flow problems
- Incentivises buyers to purchase from the country offering credit, in the form of bilateral credit lines
- Helps diversify markets and buyers

Role of Export Finance in Addressing Sri Lanka's Export Problems

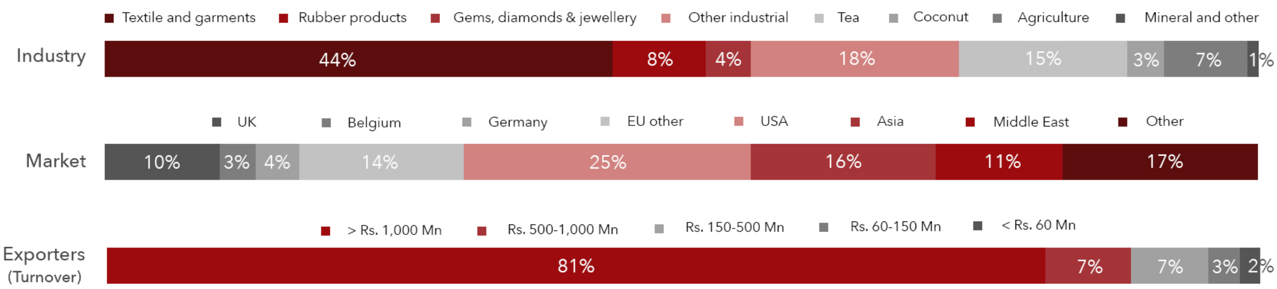
Export Finance can play an important role in reviving exports of the country. It can complement the initiatives taken to address some of the critical factors that undermine the performance of the export sector.

Sri Lanka's export sector faces several challenges (Figure 2). First, the country heavily depends on highly labour intensive export sectors such as apparel and tea, whist not having a comparative advantage in labour compared to other competing countries such as Bangladesh and Vietnam. For example apparel and tea alone account for over 50% of the value of exports. Second, the country heavily depends on a few export markets such as USA and the EU where the growth in demand for imports have been stagnating for a significant time period. Third, the country heavily depends on a few large exporters to generate most of the export revenue and SME contribution to exports is low.

There are a large number of SMEs[2] registered as exporters. However, they contribute to a mere 4.4% of total export turnover. Overall, compared to other countries and regions, while the number of SMEs remain large, their contribution to the economy remains low (Figure 3).

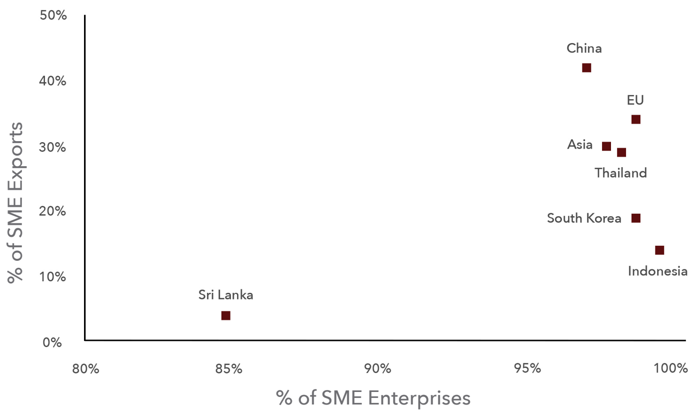
Export Finance can play an important role in addressing these constraints faced by the export sector; it can help secure export orders by enabling exporters to offer competitive payment terms to buyers, it can facilitate increased participation of SMEs in international trade and diversification of products and markets.

Figure 2: Sri Lanka's export concentration



Source: Industry and market export values from Annual Report 2014, Central Bank of Sri Lanka, Exporter turnover values from Export Performance Indicators 2004-2013

Figure 3: Contribution of SMEs to exports and total number of enterprises (selected countries)[3]



Source: Annual Report 2014, Central Bank of Sri Lanka, Export Performance Indicators 2004-2013, Asia SME Finance Monitor 2013, ADB

Help secure export orders

Availability of different Export Finance solutions to obtain credit and to mitigate risks at competitive rates increases the ability of exporters to offer payment terms more favourable to buyers such as long credit periods and open accounts trading. This in turn, enhances their ability to secure export orders. Whereas, if exporters are unable to offer attractive payment terms to buyers, they may lose export orders to their competitors. Therefore, taking steps to encourage financial institutions to increase the portfolio of Export Finances available and ensure that exporters can access finance at competitive rates can help promote exports.

IF EXPORTERS ARE unable to offer attractive payment terms to buyers, they may lose export orders to their competitors. Therefore, taking steps to encourage financial institutions to increase the portfolio of Export Finances available and ensure that exporters can access finance at competitive rates can help promote exports.

Facilitate SME participation in exports

The need to offer payment terms more favourable to buyers, impose a greater burden on small and medium enterprises than on large exporters. Inherently, SMEs are considered high risk borrowers and hence have difficulty in accessing financing that is equitably and affordably priced. This is because banks, who are the main providers of Export Finance, prefer to service large and global corporates and have limited interest in engaging with SMEs. Research finds this to be particularly persistent in developing countries than in the developed countries.[4] Therefore, facilitating access to Export Finance at reasonable costs is critical to increase the contribution of SMEs to exports. Examples of Export Finance solutions that can facilitate SMEs are government guaranteed export working finance facilities that help incentivise banks to increase lending to SMEs at competitive rates, government backed export credit lines for SMEs to acquire new technology/upgrade skills and value chain financing programs aimed at granting access to finance for SME suppliers on the back of the borrowing capacity of large buyers.

Facilitate access to new markets

Sri Lanka's exports have been growing at an intensive margin; i.e.by selling more of the same products to the same markets. This is a key factor that contributes to lacklustre performance in growth. Growing at the extensive margin i.e. by selling new products and accessing new markets is challenging. The Export Finance premiums vary according to the terms and conditions of the export credits, particularly their duration, as well as the credit rating or risk status of the importer or the importer's bank and of the importing country concerned. It is relatively easier to obtain funding from private banks at reasonable rates when exporting to established buyers in advanced country markets. The cost and availability of finance becomes a greater problem when exporting to buyers in developing country markets where perceived commercial and country risks tend to be high. International banks generally apply strict country credit ceilings and impose high risk premiums on lending to developing countries.

The government can address this problem by providing Export Finance solutions that take on some of the risks private banks are unwilling and unable to take and by providing updated and reliable information to help private banks assess commercial and country risks accurately. Furthermore, governments can introduce credit schemes such as bilateral lines of credit to facilitate access to target markets. This is specially a useful tool in facilitating trade with developing country markets, where cost and access to credit to buyers in their own markets can be a significant barrier for them to engage in international trade. These credit lines are offered by the exporting country to the importing country to buy products from their country. This incentivises importers/buyers in the credit receiving country to buy from the credit providing country as opposed to buying from another country. This is widely used financing instrument by most developed and middle income countries to promote exports to developing and emerging country markets.

Limitations of Export Finance in Sri Lanka

Four critical demand and supply constraints relating to information, institutions, instruments and current structure of exports prevent Export Finance from playing a more proactive role in facilitating and promoting exports in Sri Lanka. Lack of credible, updated and timely information about buyers and markets and resulting over estimation of risk and overpricing of Export Finance solutions has a negative impact on supply. Lack of information about Export Finance instruments and their benefits has a negative impact on demand. The institutional deficiencies in terms of capacity, competency and independence as well as the limited portfolio of Export Finance solutions available in the market, negatively affects supply. Low risk export environment composing of established large exporters having long standing relationships with established buyers in established markets results in low demand for Export Finance solutions.

The key areas covered in this section are:

- Lack of credible, updated and timely information
- Institutional deficiencies
  - Sri Lanka Export Credit Insurance Corporation (SLECIC)
  - Commercial banks
  - Export Promotion Agencies (EPAs)
  - Credit Information Bureau (CRIB) of Sri Lanka
- Current low risk and static export structure
- Limited portfolio and utilisation of Export Finance solutions

Lack of credible, updated and timely information

Information plays a critical role in facilitating a well-functioning Export Finance market, and in determining the ease and cost of accessing Export Finance. Both, the exporters and financial institutions need information to assess risks. Reliable, accurate and updated information about the exporter, the buyer and the market is critical in being able to accurately assess risks. Risks that are clearly and objectively communicated and understood can be equitably mitigated and managed. Absence of information and visibility tends to result in overestimation of risk, particularly when risk assessors have limited international experience, and thus, the pricing of risk mitigation options can be inflated unnecessarily.

Sri Lanka's Export Finance sector suffers from two types of information asymmetries; first is related to limitations in buyer, market and exporter information and second is related to lack of awareness/information among exporters about Export Finance solutions and the benefits.

According to research, ease of finding buyer and foreign market information is low and the cost is high, especially with respect to emerging markets. This undermines the ability to accurately assess commercial and country risks. Therefore, lending institutes often base their assessment of risk largely on the track record of the exporter (whom they have confidence in to have done their own due diligence of the buyer). This means the new exporters and SMEs find it challenging to access Export Finance at a reasonable cost. The high cost of finance results in low demand, low level of utilisation of Export Finance solutions and lower SME participation in exports in the country.

The awareness among exporters (especially SMEs) of the types of Export Finance solutions available, its costs and benefits is low. In addition to the cost of finance, low level of awareness is another reason for the low demand and utilisation of Export Finance. Further to this, exporters' lack of technical competency to approach banks for financing and in deciding the best financing options is also an issue. Mismatching Export Finance solutions also costs exporters, as little knowledge in the area has resulted in short term capital being obtained for long term operational decisions and vice versa. Exporters have to go through a balance sheet restructuring in order to match the credit periods; this is both time consuming and costly.

The financial institutes as well as exporters were not aware of the initiatives taken by the government to address some of the information asymmetries. For example, most banks and exporters were not aware of the Secured Transactions Registry (STR) established by the Credit Information Bureau (CRIB). The STR is a movable collateral registry, launched in 2011 to improve the flow of low cost credit to the underserved sectors of the credit market. A collateral registry allows movable assets such as inventory, machinery and equipment, accounts receivable, cash flows and livestock to be registered as a security interest and realised in the event of a default. The collateral registry is a unified and centralised system accessible to all registered financial institutions. When a borrower pledges movable collateral at a bank, the bank is able to check if this security has been pledged elsewhere with another bank and if it has been, the bank can know his priority on claims on the collateral. This helps to improve access to finance for SMEs, who do not have fixed assets to offer as collateral, but have movable assets.

Export promotion agencies (EPAs) and export credit agencies (ECAs) in general play an active role in addressing information asymmetries and gaps. Most EPAs and ECAs make special efforts to raise awareness among SMEs about official export credit programmes (refer Table 2). In Sri Lanka, information services provided by both EPAs and ECAs to facilitate Export Finance remain low. A study done by the Commonwealth on the subject confirms these findings, it states that "(in Sri Lanka) whilst considerable government and regulatory support to banks and exporters has been extended, greater awareness amongst exporters, dissemination and dialogue appear to have scope for improvement".

In addition to information about export credit facilities, limited technical competence in finance (e.g. preparing credible loan and financial requests) is another reason that small businesses find it difficult to access finance at a reasonable cost. Through awareness creation and training and by improving the flow of information, the demand and access for Export Finance solutions (especially for SMEs) can be improved significantly. Information deficiencies also undermine the ability of financial institutions to develop innovative, tailor-made financial packages (e.g. VCF) to support the export sector in general and the SME sector in particular.

The flow of information is inadequate in Sri Lanka, partly due to deficiencies in the institutions established to promote and facilitate exports. The institutional deficiencies are discussed in detail in the following section.

Table 2: Information services provided by ECAs in other countries

ECA Canada	Service	Canada sends out 800,000 direct mailings throughout the year and its SME representatives, stationed in major centres, make presentations and participate in seminars, trade shows and other government information sessions across the country. Canada also runs advertisements for SME exporters in the print media and on television.
Nippon Export and Investment Insurance (NEXI) of Japan & JBIC of Japan	Service	Provide information on export credits to small firms in the context of international investment seminars targeted at smaller enterprises. JBIC offers advisory and consulting services and organises lectures, seminars, study meetings and various forums to support SMEs.
Export Finance and Insurance Corporation (EFIC) in Australia	Service	Provide direct marketing, publications, seminars, and interactions with other government organisations responsible for assisting SMEs as well as the banking community.
HERMES in Germany	Service	Advisory services focused on SMEs, including an SME telephone hotline providing personalised support regarding export credit services.
EXIM Bank of India	Service	The bank publishes Agri-Export Advantage, a quarterly newsletter in over ten local languages. It covers various export products, their past performances and export potential in the future.
EXIM Bank of Thailand	Service	The Bank's CSR conducts 'Learning to Export' training programmes for SMEs, with seminars on enhancing export shares to ASEAN countries and mitigating international trade risks. The Bank also has a monthly e-newsletter that has coverage of over 12,000 subscribers. It also makes available online 'Opening the World of Export Opportunities for SMEs', a document with economic information on international trade and Thai investments on a monthly basis.
EXIM Bank of Malaysia	Service	The Bank's Advisory & Research department publishes country assessments and industry assessments (approx. two summaries per month) on their website.

Source: Officially Supported Export Credit and Small businesses, OECD, EXIM bank of India website and Annual report (2014), EXIM bank of Thailand Annual report (2014), EXIM Bank of Malaysia website

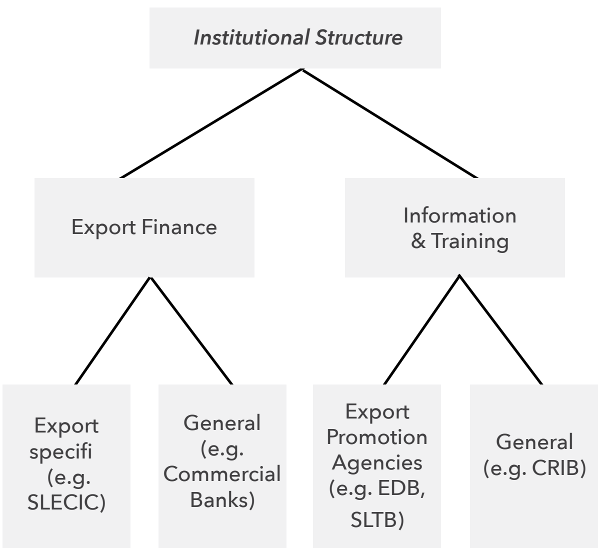
Institutional Deficiencies

Sri Lanka has a number of institutions that can facilitate and promote the use of Export Finance in the country (refer Figure 4). These institutions can be divided into two broad categories in terms of their core functions; first, are institutions that directly provide Export Finance and second, are institutions that provide information and training which can facilitate and promote availability and utilisation of Export Finance.

In terms of Export Finance providers, the Sri Lanka Export Credit Insurance Corporation (SLECIC) functions as the official export credit agency (ECA) of the country. In addition to SLECIC, other financial institutions also provide Export Finance (e.g. commercial banks). In addition to providing Export Finance, ECAs also provide information. In terms of information and training providers, there are institutions that provide information in general to facilitate lending, such as the Credit Information Bureau (CRIB) of Sri Lanka. There are also institutions that provide information and training specifically to the export sector such as the Export Development Board (EDB) and other sector specific institutions such as Sri Lanka Tea Board (SLTB) and the National Gem and Jewellery Authority.

Although these institutions can play an active role in facilitating and promoting the use of Export Finance, at present their focus on Export Finance is low. The research finds several deficiencies in the current institutional framework; first, limitations in skills, capacity and expertise, and second, low level of policy focus, government support and initiative to facilitate Export Finance. The core functions of the existing institutions and their deficiencies are discussed in detail below.

Figure 4: Institutional Framework in Sri Lanka



Sri Lanka Export Credit Insurance Corporation (SLECIC)

SLECIC was established in 1978 and is the official export credit insurance agency of Sri Lanka. It provides Export Finance facilities such as insurance policies to exporters against non-receipt and delayed receipts and guarantees to banks to secure pre- and post-shipment finance. In addition to that, SLECIC provides to a limited extent market and buyer reports. According to the Commonwealth study on export credit, the limitations of SLECIC are its "narrow client base, limited coverage of the country's exports, and little sustained engagement with commercial banks".

SLECIC also has limitations in terms of resources and skills required to deliver the services (e.g. analysing risks) to the clients' satisfaction. The Commonwealth study finds SLECIC lacking technological infrastructure, internal capabilities (including monetary and human capital) and risk management systems. The credibility of the institution with the banking sector in the country has been dented due to past incidents of not honouring its commitments. As a result, the banks have to some extent lost confidence in the credit guarantees provided by the organisation. This in turn has had adverse impact on the demand for Export Finance solutions provided by SLECIC.

As per the SLECIC Act No.15 of 1978, it can provide a variety of Export Finance solutions to exporters than what is provided at present. For example, the Act permits provision of refinancing facilities to financial institutions but SLECIC does not offer this service, whereas in most other countries this is a service provided by the ECA.

In general, ECAs also provide information services such as information about markets, buyers, export and import procedures, export opportunities and provide guidance especially to SMEs (refer Table 2). In comparison, information services provided by SLECIC is limited and the organisation does not have a website to disseminate information. SLECIC provides buyer assessment reports on request, but due to lack of confidence in capacity and expertise, the demand for these reports remain low. Although SLECIC maintains a list of buyers who default payments, this is not regularly updated and the information is not shared with other financial institutions.

Commercial Banks

While SLECIC offers guarantees it does not provide export credit, therefore, commercial banks are Sri Lanka's primary providers of credit for exporters. The banking sector in Sri Lanka includes 25 licenced commercial banks and 9 specialised banks, of which

23 are local and 11 international. Banks have a high dependency on trade finance (both import and export) with the third largest category of lending being trade finance.[5] The total percentage of trade finance in commercial banks is between 12-15% of the total loan and advances portfolio.[6] Of this, share of export lending has been declining (from 58% in March, 2011 to 40% by December 2012). This is mainly due to higher growth in imports compared to exports. In addition to lending, fees and bank charges in trade finance transactions accounts up to 50% of the total fee income.[7]

As mentioned in Section 2.2, private sector institutions tend to focus more on providing short term (up to one year) Export Finance and on financing large exporters and exports to lower risk high-income and more advanced economy markets. Commercial banks in Sri Lanka also show similar trends. The reasons identified include lack of technical expertise to assess commercial and country risks and high cost and time taken to find the required information to assess risks. Another is low demand for Export Finance solutions due to low risk export structure of the country which is discussed in detail in Section 3.3.

Export Promotion Agencies (EPAs)

Sri Lanka has a number of EPAs. Export Development Board (EDB) is the main agency that is established to promote all exports. EDB provides various services to support exporters; these include formulation and implementation of export strategy of the country, provision of information, advice and training to exporters and providing financial support to exporters (e.g. to participate in exhibitions). However, attention given to Export Finance by EDB is low in its export strategy as well as in other services provided such as information and training. For example, most other countries have made available comprehensive guides to Export Finance specially targeting SMEs, but Sri Lanka does not provide this information to exporters at present. Although EDB has a website, there is limited information provided through the site to exporters and financial institutes about markets, buyers and about Export Finance.[8]

There are sector specific government organisations that also promote exports such as the Sri Lanka Tea Board, the Department of Export Agriculture, National Gem and Jewellery Authority. These organisations also provide similar services that are provided by EDB, tailor made to their specific sectors. These organisations have sector specific information with regard to potential markets, buyers and exporters that can help financial institutions assess risks better. However, there is no system of regularly updating the information and sharing the information with relevant agencies and stakeholders.

Credit Information Bureau (CRIB) of Sri Lanka

The CRIB collects and collates credit and financial information on borrowers and prospective borrowers of lending institutions and provides credit information on request to shareholder lending institutions and simultaneously to borrowers to whom such information relate and help instil credit discipline in the financial sector. Credit bureaus facilitate finance by 1) *improving banks' knowledge* of applicants' characteristics and permit more accurate prediction of repayment probability, 2) *reducing the informational rents* that banks could otherwise extract from their customers, 3) working as a *borrower discipline device:* every borrower knows that a default damages his reputation with other potential lenders, cutting him off from future credit or making it more expensive and 4) *eliminating the incentive to over-borrow* when borrowers draw credit simultaneously from many banks without any of them realising.[9]

A deficiency of the Sri Lankan CRIB with respect to facilitating financing of international trade is services at present being restricted to providing information about local borrowers to local lending institutes. In order to facilitate financing of international transactions, CRIB needs to extend provision of information about foreign buyers to local lending institutes and about local exporters and importers to foreign lending institutes. This requires CRIB to link up with other credit information providers in key export markets. Further, as discussed in Section 3.1, initiative to create awareness of initiatives taken by CRIB to address information asymmetries (e.g. STR) is low.

Current Low Risk and Static Export Structure

The low level of utilisation of Export Finance in the country is partly the outcome of the export structure of the country which is low risk and static. The export revenue is heavily dependent on few large exporters, few products, few markets and few buyers with long standing relationships (refer section 2.4). This low risk environment has led to low demand for innovative export financial solutions. The Commonwealth study on export credit industry in Sri Lanka states that "there is lack of risk appetite for increasing international trade among most Sri Lankan exporters who tend to rely mostly on open terms transactions with long standing buyers. Diversification of markets and buyers, modification of terms etc. have not been preferred by established exporters". The report also finds that two-thirds of Sri Lanka's exports are conducted on open account terms. Exporter willingness to trade on open account terms remains high because the trade is with long standing buyers who have not defaulted payments.

Further, the Commonwealth study confirms that the country has failed to recognise the role Export Finance can play to incentivise exporters to diversify products, markets and buyers and encourage domestic companies that have not hitherto exported to enter international markets (especially SMEs). As a middle income country, in order to revive exports Sri Lanka need to diversify away from low skilled, labour intensive exports in which the country no longer has a comparative advantage. This requires finding new markets, products, buyers and encouraging more domestic entrepreneurs to venture into international markets. The role Export Finance can play in this regard is not sufficiently recognised in the country.

Limited Portfolio and Utilisation of Export Finance Solutions

The Export Finance market in Sri Lanka, like many other developing countries remains under-developed. The utilisation of available Export Finance instruments is low. For example, percentage of export transactions covered by export credit guarantee/insurance is around 2-4% in Sri Lanka compared to the international average of 10-12%.[10] The variety, availability and sophistication of Export Finance solutions available in the market remain limited. This is the combined outcome of low level of awareness, lack of policy focus and recognition given to the role Export Finance in promoting exports, lack of initiatives by the government, institutional deficiencies and the current low risk and static export structure.

In comparison to the Export Finance solutions available to facilitate exports (refer Section 2.3), the portfolio of such solutions available to Sri Lankan exporters remain limited. Examples of Export Finance solutions that are not offered at present are export factoring, buyer credit, and bilateral export credit lines. Although SLECIC has a wide range of products in its financial offerings, the organisation offers only a limited number at present. For example, section 5 of the SLECIC Act listing objects refers to provision refinancing facilities to banks and other financial institutions in respect to credit facilities granted by such banks and institutions for the promotion of exports,[11] but SLECIC does not provide export refinancing at present. There is a need to introduce more products to meet emerging needs of exporters.

Further, the few available Export Finance solutions remain under-utilised. Examples are Value Chain Financing (VCF) and export credit and payment default guarantee schemes. VCF for cinnamon sector introduced by the National Development Bank (NDB) is a good example of how VCF can help promote exports and improve access to finance to direct and indirect exporting SMEs (especially in the agricultural sector). "Cinnamon to the World" scheme is implemented by NDB in collaboration with both public and private sector export promotion organisations (EDB, Spice Council, and Spices & Allied Products Producers Association). VCF increases the financial credibility of the SMEs down the value chain because they are backed by larger exporters/trade association. There is room to expand similar financial assistance programs to other potential export agricultural products.

2 - 4 percent

Export transactions covered by export credit guarantee/insurance in Sri Lanka

10 - 12 percent

International average of export transactions covered by export credit guarantee/insurance

Practical Interventions to Improve Export Finance

Section three outlined in detail the main demand and supply side problems of the Export Finance market in Sri Lanka. It is evident that these problems are inter-connected. Therefore to facilitate and promote Export Finance, it is important to take steps to address the demand and supply constraints simultaneously. This final section outlines four key interventions that can help promote availability and utilisation of Export Finance in Sri Lanka. These are 1) introducing new, innovative Export Finance solutions, 2) improving access to reliable and updated information at lower cost, 3) improving capacity, credibility and independence of institutions and 4) setting up an Export Import Bank.

The key areas covered in this section are:

- Introducing new and innovative Export Finance solutions
  - Special export credit facilities targeting SMEs
  - Value chain financing
  - Export credit refinance window
  - Bilateral export credit lines and buyer credit
  - Export factoring
  - Special credit schemes targeting first time exporters
- Improving access to reliable, updated information and lower cost
- Improving capacity, efficiency and credibility of institutions
- Setting up an Export – Import (EXIM) bank in Sri Lanka

Introducing New & Innovative Export Finance Solutions

Export Finance can play an important role in improving competitiveness of exporters and facilitating diversification of export structure of Sri Lanka. However, introducing new and innovative Export Finance solutions need to be complemented by shift in Sri Lanka's export policy and execution to create a more dynamic and diversified export structure. Few examples of new and innovative Export Finance instruments that can facilitate and promote exports in the country are given below.

Special export credit facilities targeting SMEs

SME participation in exports in Sri Lanka is lower compared to other countries. The country heavily depends on few large established exporters to bring most of the export earnings. Access to finance remains a significant obstacle for SMEs looking to become exporters. Specially designed export financing tools that are in line with the fast pace of business and the specific needs of export-driven SMEs can help SMEs overcome export-related financing challenges. For example the delay between shipping the goods and receiving payment creates a short term cash flow crunch for exporters. This is especially acute for SMEs that lack sufficient internal liquidity. The result can be the inability to purchase raw materials and services required to fulfil other export orders and therefore the loss of revenue and business. Access to working capital finance solutions at affordable prices is important to address this problem by providing exporters with needed funds while waiting for payment from the foreign buyer. This helps to ease and stabilize the cash flow problems of exporters, and enable a smooth progression of the business.

At present financial institutions in Sri Lanka do not offer specially packaged finance facilities targeting exporting SMEs. In contrast, most other countries have specially designed export-related products and services catering to the special needs of small exporters. For example, many Organisation for Economic Co-operation and Development (OECD) countries have introduced into their official export credit systems special schemes and services provided through export credit agencies to assist smaller exporters. These initiatives include information programmes, fast-track application procedures, and special export insurance, guarantees and other products. SME programmes are designed to address the difficulties encountered by smaller enterprises in applying for and receiving export credits and related services.

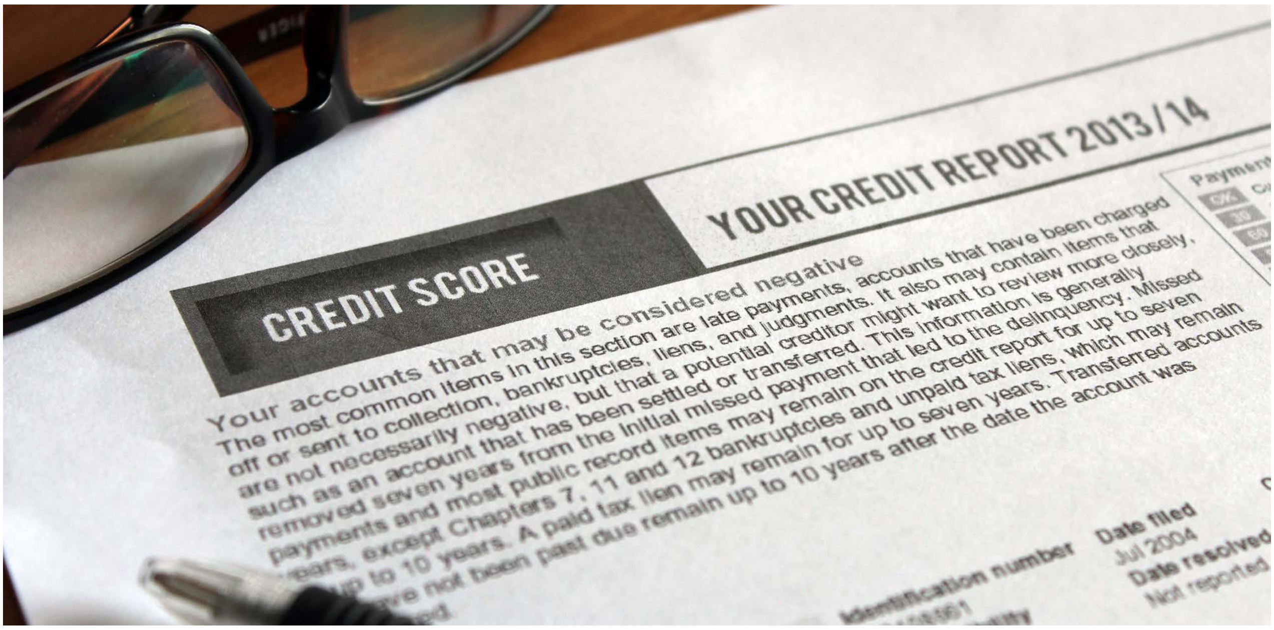
Most SME programs introduce streamlined or simplified application and review procedures for export credit services for SMEs. Small exporters, which are usually less experienced and require more hand-holding to guide them through an export credit system, generally have different needs than larger companies. The Commonwealth study also recommends setting up of a Credit Guarantee Fund for Micro, Small and Medium Enterprises (CGMSE) that will provide risk cover to commercial banks to enable the latter to finance Micro, Small and Medium Enterprises (MSMEs) for exports on merits without collaterals. According to the study the CGMSME may be managed by SLECIC in its fiduciary capacity and it is expected to encourage banks to lend to MSMEs for exports.

Value Chain Financing (VCF)

This is a form of financing that is beneficial to agricultural SMEs that has become very important in determining trade competitiveness. VCF is important not only in enhancing export competitiveness, but also in developing sustainable agricultural systems, alleviating poverty and promoting financial inclusion.VCF may be initiated or driven by the producer (such as by small or large-scale farmers associations), the buyer (processors, exporters or traders), a facilitator (such as a Non-Government Organistion (NGO) or government organisation), or it can be an integrated model (led by a supermarket or multinational). Sri Lanka already has initiated VCF (refer Section 3.4). However, there is scope for expansion to cover other agricultural products. According to research, there are many options for mobilising financing from outside the value chain, ranging from the regular finance (term loans, overdrafts, and lines of credit) to less common finance options such as factoring, equity, joint ventures and commodity exchanges. There are also various solutions and methods for mitigating the risks (market or price risks, crop or weather risks, production-related risks, collateral risks, or human factors) that plague agri-business finance. VCF will enhance financial credibility of SME exporters and help enhance capacity in terms of upgrading skills, quality and technology used in production to meet buyer requirements. It is an underutilised Export Finance instrument that can help promote exports of Sri Lanka.

Export Credit Refinance Window

This is a facility that is not available in Sri Lanka at present. The Commonwealth study recommends setting up an Export Credit Refinance Window at Central Bank of Sri Lanka (CBSL) both in Sri Lankan rupees and in selected foreign currencies, for commercial banks against their eligible Export Finance portfolio. CBSL may stipulate attendant conditions for export credit flows to sub serve policy goals, such as support for non-traditional exports. According to the study,



export credit refinance increases the liquidity available to exporters at competitive rates.

Bilateral Export Credit Lines & Buyer Credit

Bilateral export credit lines are widely used by countries to export products to target markets. Providing a credit line at a concessionary rate to the target export market will incentivise importers in that market to purchase products from Sri Lanka over similar products from another country. This is specially a useful tool to access developing country and emerging markets as it will reduce the commercial risk faced by exporters and incentivise them to export to new emerging country markets. At present this kind of Export Finance facilities are not offered by the government of Sri Lanka to exporters.

Buyer credit is another Export Finance solution that is not available in Sri Lanka. Bilateral export credit lines are a form of buyer credit. In addition to credit lines offered by the government or government backed financial institutes, buyer credit can also be facilitated by ECAs or Banks to individual exporters. A buyer credit is a financing arrangement between the Bank and a foreign importer or importer's bank that is separate from the commercial contract. The advantage for the exporter is that the commercial contract can be settled on a cash basis as the financing is negotiated between the Bank and the importer or, more often, the importer's bank. The Bank may require a guarantee from an export credit agency to facilitate buyer credit.

Export Factoring

With increasing pressure from foreign buyers to trade on open accounts, facilities like factoring can help exporters to offer such payment terms whilst mitigating the risks involved. This financing facility is not available in Sri Lanka at present. Export factoring is a complete financial package that combines export working capital financing, credit protection, foreign accounts receivable bookkeeping and collection services. Export factoring is offered under an agreement between the factor and exporter, in which the factor purchases the exporter's short-term foreign accounts receivable for cash at a discount from the face value, normally without recourse, and assumes the risk on the ability of the foreign buyer to pay, and handles collections on the receivables. Thus, by virtually eliminating the risk of non-payment by foreign buyers, factoring allows the exporter to offer open accounts, improves liquidity position, and boosts competitiveness in the global marketplace. Factoring foreign accounts receivables can be a viable alternative to export credit insurance, long-term bank financing, expensive short term bridge loans or other types of borrowing that will create debt on the balance sheet.

Special credit schemes targeting first time exporters

There are large a number of companies that are successful in the domestic market, but reluctant to enter foreign markets. High risk perceived and lack of information and awareness are factors that prevent these companies from exporting. Export Finance coupled with better information about markets and buyers can be used to incentivise such companies to export. The Commonwealth study for example recommends creation of a category of 'first time exporters' who will be eligible for risk cover from the Credit Guarantee Fund for MSMEs (CGMSE) at nominal/nil premium for

Improving Access to Updated, Reliable Information at Lower Cost

Research by the International Finance Corporation (IFC) confirms that lending is higher and credit risk is lower in countries where lenders share information, regardless of the private or public nature of the information-sharing mechanism. Further, cost of information can be reduced and ease of access can be improved by having a centralised platform of information which can be shared by multiple stakeholders electronically.

SLECIC as well as other EPAs like EDB can play a significant role in terms of improving availability of information to exporters and financial institutes to better assess risks. Initiatives taken by similar organisations in other countries are listed in Table 2, Section 3.1. EDB for example can liaise with commercial sections of Sri Lankan embassies abroad and compile market and buyer information products on a regular basis and make such products available to both exporters and financial institutions. Sector specific institutions have specialised knowledge about their respective sectors which can help design special Export Finance programs (e.g. VCF) tailor made to meet the needs of specific sectors. Organisations like CRIB can help better assess and mitigate commercial risks by linking up with credit information providers in other countries. Research has shown that credit information sharing substantially improves the quality of default predictions.[12]

It is important to introduce procedures and provide training to enable organisations like EDB to be able to collect and compile information in a manner that meet client requirements. Even if the information is made available for a fee, when made available through a centralised system to multiple users the cost will be lower and efficiency of collecting and compiling information will be higher compared to individual firms and banks compiling the same information.

Government organisations like the EDB as well as sector specific EPAs (both private and public) can play an active role in creating awareness among exporters about Export Finance, the benefits and provide training to increase the financial and technical competence of SME businesses to enable them to access finance at a reasonable cost. Public seminars, private events (e.g. trade shows), printed media and the Internet can be used to disseminate information to SMEs on export credit products and export support services available.

Improving Capacity, Efficiency and Credibility of Institutions

The key weaknesses in the institutions established to facilitate finance and promote exports in Sri Lanka are limitations in skills, capacity and expertise on the subject and low level of policy focus, government support and initiative to facilitate Export Finance. In order to facilitate and promote use of Export Finance, the institutions need to be strengthened by taking steps to address these weaknesses.

The Commonwealth report on export credit industry in Sri Lanka provides detailed recommendations to strengthen SLECIC. First, is related to increasing the export insurance products and services offered by SLECIC and to increase the attractiveness of these products to clients (and introduce special facilities to support MSMEs). Second, is to take steps to enhance credibility and improve working relationship between SLECIC and other financial institutes of the country. The report makes several recommendations to improve the organisational structure of SLECIC. For example, the report recommends establishing an advisory board comprising of exporters, academic experts, bankers, professionals to enhance its ability to formulate strategies and products to meet client expectations and emerging market needs. In order to enhance credibility, professionalism and independence of the organisation, the report also recommends amending the SLECIC Act provides for independent directors to be nominated from industry, banking, and academia. Other recommendations include upgrading technology infrastructure and internal capabilities, risk management systems and investing in monetary and human capital.

In addition to taking steps to improve services provided by SLECIC, EPAs as well as financial sector information providers such as CRIB need to link with similar organisations abroad and play a proactive role in compiling and sharing information that can help accurately assess commercial and country risks in target export markets. It is important to develop networks and skills to compile information especially about target developing and emerging market economies. The risk of doing business with these economies is relatively higher in comparison to developed countries and finding accurate and reliable information is more difficult and costly.

Recognising the role Export Finance can play in diversifying and promoting exports and proactive government involvement in supporting institutes to facilitate and promote use of Export Finance is critical in this regard. For example, moral suasion can be used by CBSL to encourage financial institutes to lend to exporting SMEs and exporters venturing into new markets. Moral suasion is an a tool used by monetary authorities to persuade (instead of coerce through law making power) financial institutions in following suggested guidelines on the availability and cost of credit. Moral suasion is used typically by making policy announcements to induce the desired response, before resorting to mandatory compliance through statutory regulations.

Setting up an Export-Import Bank in Sri Lanka

Research confirm that export credit agencies play a critical role in emerging markets in promoting trade, particularly facilitating SME participation in international trade.[13] EXIM banks are found across countries both developed and developing and some are fully owned by the government, some fully owned by private sector and some public-private partnerships.

In Sri Lanka although SLECIC Act envisages the organisation to provide a wide spectrum of export credit facilities and services, as discussed above, at present, the services and facilities offered by the organisation is limited. Although the banking sector provides Export Finance, they mainly cater to large established exporters and mainly facilitate trade with advanced countries where the risk is relatively low. In addition to these market gaps, the low level of participation of SMEs in exports, low level of private-sector lending in the SME segment, lack of specially designed export credit schemes meet the needs of SMEs, significant asymmetries and gaps in information and limited training and capacity building initiatives clearly highlight the need for an EXIM bank for Sri Lanka.

The Commonwealth report also recommends setting up an EXIM Bank of Sri Lanka to function as the apex financial institution in the country for exports, which will be proactive, innovative in its financing. Given the urgent need to make the export sector more dynamic and diversified, it is timely for the country to think of an EXIM bank which will provide financial support to exporters of new and non-traditional exports, who want to access developing and emerging country markets. The low risk appetite of existing exporters hinders diversification of marks and products. The low risk appetite of banks hinders participation of SMEs in international trade. EXIM bank can help address both these issues by taking over the risks that private sector in general is unwilling and unable to take.

EXIM banks in general facilitate Export Finance by assuming both credit and country risk that other financial institutions are unwilling to assume. Generally they do not directly compete with other financial institutions; they absorb exporters who do not qualify under regular financial institution assessment. In other words, they step in to address private market failures. For example EXIM banks sell some if its own products through commercial banks. Further they play an active role in teaching and training staff of private banks. The challenge to overcome in Sri Lanka in setting up an EXIM bank is to ensure that it does not have the deficiencies common to other government institutes in the sector such as SLECIC and EPAs like the EDB. It is important to ensure that the organisational structure allows the bank to be independent, competent and devoid of political interventions in filling key positions and distributing funds.

End Notes

[1] OPUS Services International Inc. and SWIFT (2013), Observations on the Evolution of Trade Finance and Introduction to the Bank Payment Obligation.

[2] Export Development Board has defined SMEs into two tiers of below Rs.60 million in export turnover and Rs. 60-150 million in export turnover.

[3] It is important to note however, the definitions used to define SMEs by countries vary, making cross-country comparison inexact. Further even in Sri Lanka, different agencies use different definitions to categorise SMEs. For example, performance report 2013 of the Department of Development Finance of Ministry of Finance and Planning state that SME contribution to exports to be 20%. However, the definition used to categorise SME is not given in the report. This study in assessing SME contribution follows the definition used by EDB which is based on annual export turnover.

[4] COMCEC coordination office. (2013). *Improving the SMEs access to trade finance in OIC countries*.

[5] First and second being long-term credit and overdrafts

[6] The Commonwealth. (2014). Building capacity of the export credit insurance industry to enhance the international trade competitiveness of Sri Lanka.

[7] Annual Report of Bank of Ceylon (2014). Annual Report of Hatton National Bank. (2014).

[8] EDB offers buyer assessment on 11 multinational companies on their website.

[9] Jappelli. T., Pagano. M., Conference on the Economics of Consumer Credit: European Experience and Lessons from the US European University Institute. (13/14 May 2003). *Information sharing in credit markets: a survey*.

[10] The Commonwealth. (2014). *Building Capacity of the Export Credit Insurance Industry*.

[11] See Section 5(6) Sri Lanka Export Credit Insurance Corporation Act No. 15 of 1978.

[12] Dierkes. M, Erner. C, Langer. T & Norden. L., (May, 2009) *Business credit information sharing and default risk of private firms*.

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