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Export Credit Insurance, Risk classification and Current Development: Appliccation in the Czech Republic

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Abstract Credit insurance provides an opportunity for exporters to insure international territorial risks. For these purposes, credit insurance companies compile their own risk maps in order to offer the best possible credit insurance solutions worldwide. A number of variables are reflected in the parameters of credit insurance. The aim of the article is to identify the influence of the classification of territorial risk on the insurance rate of credit insurance applied on the example of the Czech Republic. Territorial risk classification is expected to be significantly affected by the Covid pandemic. The authors of the article are currently assessing the changes due to the coronavirus pandemic on credit insurance. The Covid pandemic has not only affected the assessment of risks by credit insurers but is also expected to affect the setting of credit insurance limitations. As a result, the dependence of the insurance rate on the assessment of the territorial risk of the exporting country and the buyer's assessment will deepen.

Key words country risk classification, Covid-19, credit insurance, export, territorial risk

1. INTRODUCTION

Credit insurance is one of the most widespread forms of export promotion worldwide. It provides exporters with the opportunity to insure credit risks associated with high-risk export transactions. At the same time, it is available for export transactions that cannot be insured in the private commercial insurance market. Credit insurance is closely related to territorial risks, for the coverage of which credit insurance companies offer special products. In the case of territorial risk, the state has an irreplaceable role, through state-supported export credit agencies (credit insurance companies).

Export Credit Agencies as ECAs are public agencies and entities that provide government-supported loans, guarantees and insurance to companies from their home country that seek to do business overseas in developing countries and emerging markets. ECAs operate internationally. In most countries, there is at least one export credit agency. They fund more private sector projects in the developing world than any other class of financial institution.

The financing of export credits and their insurance is internationally regulated. The basic international rules regulating the operation of export credit insurance are set out in the OECD Consensus (Arrangement on Guidelines for Officially Supported Export Credits), the implementation of which is ensured by the Working Party of the OECD Trade Directorate for Export Credits and Credit Guarantees. It also sets out the methodology for assessing the riskiness of the customer country and defines the rules for setting insurance rates.

Limitation of losses for cases of damage due to territorial risks is possible by appropriate territorial diversification of trade, credit, and investment activities of the exporter. Credit insurance thus helps exporters protect their transactions. But it also helps identify potential hazards and assess, evaluate, and manage risks.

Given that credit insurance is closely related to territorial risks, it means that changes in the field of political risks significantly affect the parameters of specific insurance products. One of the major risk factors in recent times is also the COVID-19 pandemic, which unpredictably affects the situation in individual countries. The Covid pandemic changes the view of economic development, political risks and is reflected in the risk assessment and credit insurance limitations.

The aim of the article is to identify the influence of the classification of territorial risk on the insurance rate of credit insurance applied on the example of the Czech Republic. The authors of the article try to fill a gap in the market and evaluate the effects of changes in risk classification due to new and current trends on credit insurance.

2. LITERATURE REVIEW

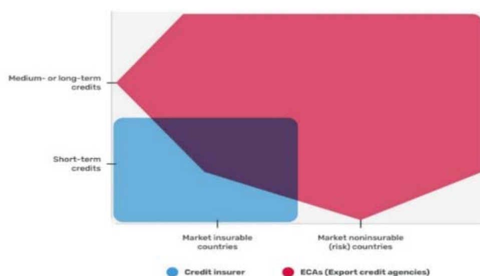
The definition of the term territorial risk is important in terms of the possibility of using insurance coverage with state support. Territorial risk arises from the uncertainty of the political and macroeconomic development of individual countries, but it can also be the result of administrative measures, natural disasters, boycotts of goods, embargoes, etc. This group of risks is difficult to quantify in advance. These are mostly risks, that may have a negative impact

on the results of individual business transactions, but also on the implementation of business plans in a particular country in the future. They have a significant impact especially on long-term international contracts and foreign direct investment. Hudakova, Masar, Luskova, Patak (2018) write about the importance of risk management in companies and the need to identify risks in the business environment.

Territorial risk can be divided into political risk, commercial political risk, currency and exchange rate risk. Although, as we know, the risks are interdependent, and management must be comprehensive. Political risk is the risk of war, blockade, internal political aspects of the state (civil unrest, strikes, expropriation), which leads to the reduction or cessation of economic relations, the inability to dispose of goods, or even the confiscation of goods. We refer the interested reader to Pahud de Mortanges and Allers (1996) or Benáček, Lenihan, Michalíková, Andreosso-O'Callaghan, Kan (2014) for an analysis of the definition of political risk. According to ECAs, political risks are force majeure from the point of view of trade participants. These include, for example, administrative or legislative measures of the debtor's country to prevent him from repaying, or also political events in the debtor's country in the form of revolutions, wars, general strikes. Furthermore, the ban on payments and the risk of a payment moratorium, which is reflected in the impossibility of payment of receivables by debtors due to the prevention caused by state measures. Commercial policy risk is represented by an embargo on the import of goods, duties, taxes, restrictions, hygiene, technical regulations, etc. Credit insurance companies that offer solutions related to the international environment compile their own risk maps to offer the best possible credit insurance solutions worldwide.

There are different export financial support systems in different countries, which are similar in their own way. One of the most important is support in the form of export credit insurance (Vávrová, 2014; Böhm, Janatka, 2004). Bakeš (2012) states that it is not possible to obtain reinsurance in a commercial way to insure territorial and long-term commercial risks. For this reason, in all countries with a significant share of exports in the economy, there are state-supported credit insurance companies (ECAs), whose activities in the area of territorial and long-term commercial risk insurance are provided by the state, usually by taking state guarantees for the activities of such insurance companies. Figure 1 graphically shows this.

Figure 1: Distribution of territorial risk coverage



Source: EGAP (2020), own elaborating

Commercial export credit insurance differs from guarantees provided by public ECAs. The key difference is that private export credit insurance usually covers short-term loans with a holding of 60-120 days, while public guarantees generally cover projects with a duration of between 2 and 5 years. ECAs and commercial insurers may, in certain cases, partially supplement or assist each other with their products. An example could be a commercial loan, which covers a part of the contract and which cannot be covered by a state agency, for example due to a down payment (for ECAs transactions, according to the OECD consensus, it is 15%). A commercial loan can also cover costs that the customer has to pay when negotiating or at the beginning of the contract and can spread these over times thanks to the loan. Of course, that commercial insurance is used in cases where the ECA cannot insure the contract on grounds of international or internal rules that must be followed. In the Czech Republic, the Export Guarantee and Insurance Corporation (abbreviation EGAP) has been authorized to operate export credit risk insurance since 1992.

There is ample empirical research on the effectiveness of export support. Interesting studies discuss the effects or relationship of public export credit agencies on the export of countries or its stimulation (Moser, Nestmann, and Wedow, 2008; Baltensperger, Herger, 2009; Berg, Beveren, Lemmers, Span and Walker, 2019). These studies reveal a positive correlation between the supply of public export credit insurance and exports. Although Baltensperger and Herger (2009) found that there is a significant dependence only on exports to developed countries, not for exports to high-risk or developing countries. Van der Veer (2015) complements a study on the role of commercial credit insurers in world trade. Rienstra-Munnicha, Turvey (2002) focused on how export credit risks affect exports and how export credit guarantees, or insurance reduce the risk of non-payment of export sales. According to Rienstra-Munnicha, Turvey (2002), goods are probably to be less exported to countries with poor credit ratings due to high default rates, and export credit insurance can be used to mitigate these risks.

The coronavirus pandemic remains a major source of uncertainty for the world economy. It also affected the credit insurance market. In response to the global situation of the pandemic, the scope of the export insurance company is expanded to provide guarantees for the repayment of credit to exporters and manufacturers. This creates an effective tool to support especially manufacturing companies with export potential in response to the COVID-19 pandemic. In practice, this means, for example, that EGAP can also participate in securing exports to the market of the largest trading partner of the Czech Republic - Germany.

The Covid pandemic also affected the risk assessment and, as we know, the parameters of credit insurance will also be affected (Berne Union, 2020; Coface, 2020; AU Group, 2020). The Berne Union report (2020) shows that The World Bank is forecasting a 5.2% contraction in global GDP for 2020 and Atradius predicts a 26% increase in global corporate insolvencies. Coface (2020) also predicts the growth of corporate insolvency up to 2021 compared to 2019. No one is likely to avoid this crisis, and the world economy has stopped abruptly and unexpectedly. The pandemic has resulted in a dramatic reduction in economic growth around the world. Coface (2020) anticipates that this trend should affect all of the main mature economies: United States (+43%), United Kingdom (+37%), Japan (+24%), France (+21%), Germany (+12%). However, many emerging economies (+44% in Brazil, +50% in Turkey) will also be disrupted by the economic consequences of lockdown measures combined with the fall in tourism revenues, expatriate workers' remittances and revenues linked to the exploitation of commodities of which prices have fallen. This has the effect of increasing short-term corporate credit risk, while also drawing attention to differences across business sectors, which may deepen compared to previous years.

Due to the pandemic, credit insurers are facing the most difficult situation since they started their business, and the extent of the expected losses is large. In countries such as Belgium, Denmark, France, Germany and the United Kingdom, credit insurers have sought state support. As a result, a state reinsurance agreement was

reached between these states and insurance companies to cope with the flood of damages expected in the second half of 2020 and early 2021. However, no agreement has been reached in other countries so far and there is no united approach. (AU Group, 2020).

3. METODOLOGY AND FINDINGS

The aim of the article is to identify the effect of territorial risk classification on the credit insurance premium rate applied on the example of the Czech Republic and to define the effects of the coronavirus pandemic on the credit insurance market and risk assessment. The authors mainly use methods of scientific work based on the evaluation of secondary data. For the analysis of the insurance rate, the authors draw data from the official website of the credit insurance company Export Guarantee and Insurance Corporation.

We will now focus on territorial risk and its assessment methodology in terms of the needs of credit insurance with state support. As part of the focus of the article, we are interested in ratings directly by credit insurance companies, however, it should be noted that there are other rating assessments of country risk. Ratings are carried out by various agencies, which are, in many cases, of great importance for further development for both investors and creditors.

The most significant impact is the political risk assessment. This can be caused by an unexpected reduction or even interruption of economic relations with the area, which leads to consequent damage to goods or unpaid receivables, loss of market processing costs, deprivation of property, etc. It is of course more pronounced in countries with political instability. Evaluation is hindered by the fact that it is relatively difficult to anticipate some policy acts and events in the longer term.

The OECD sets out the methodology for assessing the riskiness of the consumer country and defines the rules for setting insurance rates. The classification of countries according to the degree of territorial risk is carried out periodically several times a year. For the purpose to determine the riskiness of individual countries as objectively and methodologically as possible, the econometric Country Risk Assessment Model - CRAM is used. Model processes the most update macroeconomic data on the financial and economic situation from the International Monetary Fund and the World Bank and data on the payment experience of export credit insurance companies - participants in the OECD Consensus. The result is a quantitative assessment of the country's credit risk. The model is based on three groups of risk indicators, namely the payment experience of all OECD export credit agencies with a given country, the financial situation and economic stability of the evaluated countries. Subsequently, other factors are included that are not included in the input data of the model for territorial risks, especially political risk and other risks that cannot be easily quantified (OECD, 2020a). The model is not applied to OECD countries, which are classified by the World Bank as high-income countries (the Czech Republic is also included).

The country risk classification is used to consider the country's risk. The individual categories express the probability that countries or their entities will not be able to meet their obligations arising from the import of goods or services due to the economic situation of the country. Countries are classified into 8 risk categories 0 to 7, where the 7th category is represented by the countries with the highest level of territorial risk and the 1st category by the countries with the minimum level of risk. Category 0 (zero) includes countries with advanced financial markets that do not deal with territorial risks. Export operations of category 0 countries can be insured by ordinary commercial insurance companies, that means without state support. But under the conditions stated by EGAP (2020), "*that the minimum insurance rates of state-supported insurance companies should not be lower than the market rates of commercial (non-state-supported) financial institutions.*" Category 0 includes most EU countries, USA, Japan, South Korea, etc. However, even here, due to the Covid pandemic, significant changes are taking place and will continue to occur. The authors of the Aon Risk Maps report (AON, 2020) also point out that the multiplication of risk in connection with Covid-19 has shown fundamental changes in risk maps.

Although there is a uniform OECD classification, individual credit insurers are not prevented from applying their own risk assessment and evaluation. EGAP also takes over the evaluation of the OECD methodology, but complements it with its own evaluation. It uses the so-called EGAP barometer, which has an A – F scale (so 6-degree, compared to 8-degree scale of OECD). The EGAP barometer is based on the insurance company's internal assessment, which includes the country's political, economic, and financial situation. EGAP also considers the payment experience of EGAP and partner export agencies in OECD countries, the sovereign risk arising from the structure of the economy, the political situation, the legal, security and business environment, the banking sector and others (EGAP, 2020). According to the EGAP Communication (2020), EGAP insures export transactions to all countries. EGAP also applies other internal assessments of the category 7, the countries with the highest level of territorial risk, and considers some of these countries to be uninsurable. According to other studies by the authors, the resulting EGAP assessment deviates from the official OECD categorization. Not only ECAs choose its own evaluation, commercial insurers also apply their own evaluation of territorial risks.

The identified level of risk is reflected in insurance rates, which are binding for all participants in the OECD Consensus. These are the minimum insurance rates that can be used to insure export credits to a given destination country. Thus, credit insurance companies cannot, through their further reduction, favour clients from their country to the detriment of exporters from other countries and provide them a competitive advantage. The insurance companies' own evaluations can then be reflected in an increase in the insurance rate (above the level of the minimum rate). Of course, it is not realistic for all countries to assessed exporting countries identically. The result may be that there may be differences in the insurance rate for a similar project to countries from different categories, but also within one category.

The OECD sets a Minimum Premium Rate (MPR) for Credit Risk for each category. The calculation of the MPR is based on the credit rating of the country and the credit quality of the foreign debtor (Sharov, Pinskaya, Bogachev, 2018). For the calculation of the MPR for credit risks, the country rating according to the OECD classification for categories 1 to 7 is taken into account. The level of country risk in category 0 is considered negligible, therefore the MPR for category 0 is not set. The credit risk associated with transactions in countries in category 0 is mainly related to the risk of the debtor/guarantor. *The applicable MPR is determined according to the following factors: the applicable country risk classification, the time at risk, the selected buyer risk category of the obligor, the percentage of political and commercial risk cover and quality of official export credit product provided. any country risk mitigation technique applied; and any buyer risk credit enhancements that have been applied. MPRs are expressed in percentages of the principal value of the credit as if premium were collected in full at the date of the first drawdown of the credit* (OECD, 2020b).

In addition to the category of countries, the price of insurance premiums depends, among other things, on the degree of riskiness of the buyer (OECD, 2020b). The lowest risk is indicated by CCO – public entities or companies with an exceptionally good risk profile (rating AAA to B). The CC1 group is in the same price range – the debtor or guarantor has a stable and strong ability to meet obligations (rating AAA to B). Another group is CC2 – the debtor/guarantor has a good to medium repayment ability (rating A+ to B-). Group CC3 – moderate or moderately low risk (rating BBB+ to B-). The penultimate is CC4 – for which the moderately weak credit quality is below average and there is already a risk of possible interruption of repayments (rating BB+ to B- and worse). The last and weakest credit quality is the CC5 group (rating BB- to B- and worse). According to Sharov, Pinskaya, Bogachev (2018), the most favourable conditions for support for lending to exporters will be achieved when exporting products to countries with a high degree of economic and financial stability.

The authors illustrate the interdependence of the above variables with the following example (Table 1). Within the Czech Republic, EGAP offers the product Insurance of a Medium and Long Term Export Supplier Credit against the Risk of Non Payment (referred to as "C" in EGAP's offer). The insured entity is directly the exporter against the risk that the importer does not pay in the due date properly the whole owing sum, i.e. the price for the delivered goods and services (export claim). The export supplier's credit is a credit provided by the exporter to the foreign importer in the form of deferral of payment for the delivered goods or services. However, the export supplier's credit has not a character of a bank credit. In this case, the insurance conditions are ruled by the rules of the OECD Consensus. The maturity of the middle-term and long-term export supplier's credit (export receivable) is longer than 2 years and the importer must pay in advance (advance payment) minimally 15 % of the total export value (price agreed in the export contract). According to the rules set by OECD, the insured export is subject to evaluation of its influence on the life and social environment. In some selected cases, EGAP may require from the exporter an expert's opinion on the influence of export on the environment in importer´s country (EGAP, 2020).

The approximate premium rate can be calculated by the exporter on the EGAP website. The resulting rate will be specified by EGAP on the basis of a detailed analysis of the entire contract and, as we have already stated, will also depend on the buyer's analysis.

Table 1: Influence of territorial assessment on the insurance rate

Case 1.	**Risk category of the buyer SOV/CC0:**		**Risk category of the buyer CC1**		**Risk category of the buyer CC2**		**Risk category of the buyer CC3**		**Risk category of the buyer CC4**		**Risk category of the buyer CC5**	
OECD country classification	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**
1	70 000	0,70	116 000	1,16	153 000	1,53	182 000	1,82	238 000	2,38	332 000	3,32
2	116 000	1,16	166 000	1,66	204 000	2,04	249 000	2,49	306 000	3,06	396 000	3,96
3	178 000	1,78	224 000	2,24	271 000	2,71	311 000	3,11	383 000	3,83	572 000	5,72
4	261 000	2,61	303 000	3,03	358 000	3,58	406 000	4,06	558 000	5,58	716 000	7,16
5	378 000	3,78	419 000	4,19	480 000	4,80	616 000	6,16	762 000	7,62	-	-
6	487 000	4,87	528 000	5,28	683 000	6,83	823 000	8,23	-	-	-	-
7	626 000	6,26	780 000	7,80	887 000	8,87	-	-	-	-	-	-
Case 2.	**Risk category of the buyer SOV/CC0:**		**Risk category of the buyer CC1**		**Risk category of the buyer CC2**		**Risk category of the buyer CC3**		**Risk category of the buyer CC4**		**Risk category of the buyer CC5**	
OECD country classification	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**	**in CZK**	**in %**
1	9 500	0,95	17 100	1,71	23 300	2,33	28 200	2,82	37 500	3,75	53 100	5,31
2	17 100	1,71	25 400	2,54	31 800	3,18	39 200	3,92	48 800	4,88	63 800	6,38
3	27 500	2,75	35 100	3,51	42 900	4,29	49 600	4,96	61 700	6,17	92 700	9,27
4	41 300	4,13	48 200	4,82	57 500	5,75	65 500	6,55	90 400	9,04	116 700	11,67
5	58 200	5,82	65 100	6,51	75 200	7,52	97 100	9,71	121 300	12,13	-	-
6	73 500	7,35	80 400	8,04	105 100	10,51	128 000	12,80	-	-	-	-
7	93 000	9,30	116 900	11,69	134 100	13,41	-	-	-	-	-	-

Source: own elaborating based on EGAP data

Explanations to the table: Case 1: Loan amount CZK 10 million, drawdown period 35 months, repayment period 35 months. Case 2: Loan amount CZK 1 million, drawdown period 55 months, repayment period 60 months. Risk categories of buyers: SOV+...Better than Sovereign; CC0... Exceptionally Good Credit Quality; CC1...Very Good Credit Quality; CC2...Good to Moderately Good Credit Quality, Above Average; CC3...Moderate Credit Quality, Average; CC4...Moderately Weak Credit Quality, Below Average; CC5...Weak Credit Quality. Classification 0 is not included in the table, as the insurance rate in this case is based on the current market valuation of a similar type of risk.

For comparison, Table 1 deals with two cases that differ in the amount of the loan, at the time of drawing the loan and at the time of loan repayment. The amount of the loan does not affect the insurance rate. If the drawdown or repayment period is close to 60 months, the insurance rate increases. In the first case, the drawdown and repayment period are chosen at a lower level than in the second case, where the repayment and drawdown period is close to the maximum possible time. When comparing, it is clear that the insurance rate also increases with a longer repayment and drawdown period. For countries in categories 1-3, the increase in the insurance rate is not very rapid. For countries from category 4 to category 7, a significant percentage increase in the insurance rate is evident. In both cases, the insurance rate increases with a worse territorial classification of the state and also with a worse degree of risk category of the customer.

4. DISCUSSION

The effect of the classification of territorial risk on the insurance rate is demonstrated by an illustrative case where it was found that the insurance rate increases with a worse risk classification of the state and with a riskier buyer. Although the amount of the loan is lower in the second case, but the repayment period is close to the maximum possible time, the individual insurance rates are higher than in the first case.

Each insurance company strives to find out the most accurate quantitative and qualitative data, allowing the assessment of the risks assumed. The result is an in-depth analysis of each country and the different types of risk, which serves as a basis for setting prices, country risk limits and, if necessary, for specific risk acceptance conditions. The categorization of individual countries according to the degree of risk is one of the prerequisites for determining the minimum insurance rates applied to exports to these countries. In principle, the lower the risk of the destination country of export is, the lower the insurance rate is. Rienstra-Munnicha, Turvey (2002) states that exports will increase with a reduction in the probability of default, an increase in coverage or guarantee, a reduced or subsidized insurance rate, a lower risk aversion and a lower variation in pay-out amounts. Their model also shows that the offer of risk-mitigating export credit insurance makes it possible to increase the export supply. However, Baltensperger and Herger (2009) state that the offer of state-guaranteed trade credits can lead to unfavourable incentives, so exporters will take excessive risk. The results from the literature indicate that the public supply of export credit insurance is positively correlated with exports.

In connection with the coronavirus pandemic, which causes a multiplication of risks, insurance companies and exporters will be forced to supplement and often re-evaluate the rules of evaluation and classification, including evaluation criteria. Country categorizations are discussed at OECD meetings and country categorization is deteriorating (OECD, 2020). There are changes in the view of ensuring risks. EGAP CEO Jan Procházka states that during the pandemic, companies that previously did not fear the risks associated with exports are also insured. Now they want to be sure that they will get paid for their delivery. The Berne Union survey (2020) corresponds to this: "*80% of members reported an increase in new demand, most commonly for short term credit and working capital products. Around a third of respondents indicated that this includes a substantial increase in inquiries from new clients.*"

5. CONCLUSION

In the case of the export of goods or services abroad, this business relationship is defined by several factors. There are certain risks associated with these factors that may adversely affect the performance of a given business relationship. Credit insurance companies try to respond to these factors by assessing territorial risks in individual countries and offering their insurance products in connection with this assessment. Credit insurance companies base their assessment of territorial risks in accordance with established OECD rules and apply agreed minimum insurance rates when they are setting insurance rates.

An entrepreneur who has decided to export abroad has a choice of several different products, and of course the price will play a key role here. The competitive environment of state export insurance companies and commercial insurance companies in the field of credit insurance is a benefit for all involved subjects of export financing.

This article focused on defining what factors affect the insurance rate. The sample examples showed that this rate is mainly influenced by two factors - the level of territorial risk assessment and the level of assessment of the buyer's risk category. It is therefore possible to say with certainty that, at least for the EGAP insurance company, with the increasing level of territorial risk assessment, the insurance rate for insurance products also increases. The same dependence can be seen in the case of risk assessment of buyers. There, with the increasing risk category for buyers, there is also an increase in the insurance rate. However, it should not forget the fact that although you can specify general rules for determining premium rates, in the end the insurance product will always be determined based on individual conditions for the entrepreneur. Therefore, the rates may differ from the rates given in the exemplary examples.

Another big unknown, for which no one can yet estimate its consequences, is the COVID-19 pandemic. The economic impact of the pandemic will be felt by a large proportion of exporters, because most scenarios envisage a reduction in the solvency of companies. And so even problem-free customers can face financial problems. That is why the European Commission reacted and approved ECAs, including EGAP, operations in the markets of the European Union, the USA and other developed countries. Due to the pandemic, credit insurers are facing the most difficult situation since they started their business, and the extent of the expected losses is large. The situation is therefore unprecedented and will certainly have a major impact on markets around the world, and consequently on the behaviour of credit insurers. And as can be seen from the above reports, the Covid pandemic has already affected the risk assessment, which will certainly be reflected in the parameters of credit insurance.

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