Australian Government
Productivity Commission

Australia's Export Credit Arrangements

Productivity Commission Inquiry Report

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

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31 May 2012

The Hon David Bradbury MP
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

In accordance with Section 11 of the *Productivity Commission Act 1998*, we have pleasure in submitting to you the Commission's final report into Australia's Export Credit Arrangements.

Yours sincerely

Patricia Scott
Presiding Commissioner

Dr Warren Mundy
Commissioner

Terms of reference

Productivity Commission Inquiry into Australia's Export Credit Arrangements

Productivity Commission Act 1998

I, Bill Shorten, Assistant Treasurer and Minister for Financial Services and Superannuation, pursuant to Parts 2 and 3 of the *Productivity Commission Act 1998* hereby request that the Productivity Commission undertake an inquiry into Australia's export credit arrangements. The Commission's final report should be provided within nine months of receipt of this reference.

Background

The Export Finance and Insurance Corporation (EFIC) is the government provider of export credits, insurance, reinsurance and other financial services that support Australian exports and overseas investments. EFIC was established in its current form under the *Export Finance and Insurance Corporation Act 1991* (EFIC Act) as an independent statutory corporation wholly-owned by the Commonwealth of Australia. As set out in the Statement of Expectations, EFIC operates under a "market gap" mandate – it is only to provide services to viable projects where the private sector is unwilling or unable to provide support.

EFIC was last reviewed, by the Department of Foreign Affairs and Trade, in 2006. A recommendation of that review was that a future review be carried out by an independent consultant in around four years' time of that review. A further recommendation was that the next review make a thorough assessment of the costs and benefits of moving to a competitive neutrality regime, given EFIC's current exemption on the grounds that it does not compete with the private sector.

Australia now has an extensive and sophisticated capital market containing a range of commercial intermediaries providing a diverse range of services. The activities and international obligations of export credit agencies (ECAs) in Australia and internationally, as well as the trade financing role of multilateral development banks, have also undergone a considerable transformation since government export credit arrangements were established. Given this, it is appropriate that the government's role in the provision of export credits, and support for Australian exports and overseas investments through financial products and services more broadly, be extensively reviewed.

Scope of the Inquiry

In undertaking its inquiry, the Commission is to:

1. Review the rationale for, and extent of, government involvement in the provision of insurance, reinsurance and other financial services and products which support Australian export trade;
2. Review the presence or otherwise of market gaps for EFIC's products and services, and whether or not these constitute market failures, taking into account developments in the private sector's willingness and capacity to provide the insurance, reinsurance and financial services required by Australian exporters;

3. Given the above, assess EFIC's status, its objectives, and the appropriateness of current arrangements in fulfilling those objectives. This will include examining its operations against the functions in the EFIC Act and making recommendations where appropriate concerning EFIC's governance, powers, functions and priorities (including possible changes to the EFIC Act);

4. Review the scope, type, volume and delivery of products and services offered by EFIC; and the level of compliance costs for businesses accessing EFIC's financial products and services;

4.1. Assess EFIC's management of credit and funding risks;

5. Consider EFIC's pricing and service arrangements and their impact on private sector involvement in insurance, reinsurance and financial services which support Australian export trade;

5.1. Assess the impact of EFIC's pricing and service arrangements on incentives for Australian exporters to access private sector providers;

5.2. Review EFIC's exemption from competitive neutrality legislation;

6. Review EFIC's funding arrangements and capital adequacy ratio;

7. Assess the interactions between EFIC's operations and other government programs; and consider whether there are alternatives to the direct provision of financial products and services that would continue to achieve EFIC's objectives;

8. Assess the nature and quality of the information and advice provided by EFIC to the Australian Government and the public; and

9. Consider any other matter that may be relevant to the provision of export credit arrangements in Australia.

As part of its inquiry the Commission is also requested to consider, where relevant, the evolution in policies of export credit agencies internationally, including EFIC's interaction with other export credit agencies, credit insurers and multilateral agencies; developments in relevant international agreements including the OECD and the WTO; and EFIC's implementation of OECD commitments on export credits.

The Commission is to hold hearings for the purpose of its inquiry, and provide both a draft and a final report. The reports are to be published. The Government will consider the Commission's recommendations, and its response will be announced as soon as possible after the receipt of the Commission's report.

BILL SHORTEN

(Received 1 September 2011).

Note to readers

The Commission seeks to have as much information as possible on the public record. This information is available on the Commission's website. However, under certain circumstances the Commission will accept sensitive material in confidence, for example, if it was of a personal or commercial nature, and publishing it would be potentially damaging to individuals or commercial dealings.

As this inquiry relates to EFIC's place in the market and its operations (including the scope, type, volume and delivery of products and services offered by EFIC; its credit and funding risks; and the interaction between EFIC and private sector providers of export finance and insurance), the Commission was provided with material from EFIC, some of which was marked 'commercial-in-confidence'.

The Commission used this material extensively in its analysis, but has taken steps to protect the confidentiality of commercial material related to individual transactions and third parties. The Commission has generally restricted its commentary to types of transactions rather than specific transactions. The Commission has not released information about particular dealings that would identify the firm where that information is commercially sensitive and not on the public record. In most other instances the Commission has drawn information from publicly available sources.

The Commission has taken considerable care not to release commercially sensitive material. It has de-identified some material. Some material that EFIC considers commercial-in-confidence, almost exclusively relating to EFIC has been included in this report, or where the material relating to a transaction is now on the public record or dated. The Commission has released this material after considering the public interest and deliberating on what is necessary to meet the terms of reference.

The Commission has been asked to examine EFIC's operations and the delivery of its products. To do this in a rigorous and transparent way and to ensure that the evidence used by the Commission to support its conclusions is clear, it is necessary to discuss the nature and extent of EFIC's dealings with individual firms. In doing so, the Commission has relied on publicly available data and in some cases data provided to it by EFIC; the Commission's approach to the use of such data provided by EFIC is discussed above. The Commission wishes to make clear that it has only identified individual firms where it has been necessary for its analysis and it does not question the legality of the transactions involved or the motivations of EFIC's customers and their financial advisors in entering into transactions with EFIC.

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Abbreviations and explanations

Abbreviations

ACCC	Australian Competition and Consumer Commission
ADB	Asian Development Bank
ADI	authorised deposit-taking institution
AFP	Australian Federal Police
AIP	Australian Industry Participation
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
APRA	Australian Prudential Regulation Authority
ARPC	Australian Reinsurance Pool Corporation
ASCM	Agreement on Subsidies and Countervailing Measures
BU	Berne Union
CA	commercial account
CAPM	capital asset pricing model
CEO	Chief Executive Officer
CGS	Commonwealth Government Securities
CN	competitive neutrality
CRF	Consolidated Revenue Fund
CSO	community service obligation
DFAT	Department of Foreign Affairs and Trade
DHA	Defence Housing Australia
DIISRTE	Department of Industry, Innovation, Science, Research and Tertiary Education
DOFD	Department of Finance and Deregulation
ECA	export credit agency
ECG	Export Credits Group

ECGD	Export Credits Guarantee Department (UK)
ECP	euro-commercial paper
EDC	Export Development Canada
EFG	export finance guarantee
EFIC	Export Finance and Insurance Corporation
EKF	Eksport Kredit Fonden (Denmark)
EMDG	Export Market Development Grant
EPBS	Enhanced Project By-law Scheme
EPIC	Export Payments and Insurance Corporation
ERS	EFIC risk score
ESPP	Environmental and Social Policy and Procedure
EURIBOR	Euro Interbank Offered Rate
FBT	fringe benefits tax
FoI	Freedom of Information
FTE	full-time equivalent
GBE	government business enterprise
GDP	gross domestic product
GFC	global financial crisis
GGS	general government sector
GST	goods and service tax
IC	Industry Commission
IFC	International Finance Corporation
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
KEXIM	Export-Import Bank of Korea
LIBOR	London Interbank Offered Rate
LNG	liquefied natural gas
MTN	medium term note
NEXI	Nippon Export and Investment Insurance
NIA	national interest account

NZECO	New Zealand Export Credit Office
OECD	Organisation for Economic Co-operation and Development
ONDD	Office National du Ducroire (Belgium)
PC	Productivity Commission
PFC	public financial corporation
PNFC	public non-financial corporation
R&D	research and development
RISe	Reinsurance Information System
RMF	risk management framework
RoE	return on equity
RPA	risk participation agreement
RWA	risk weighted assets
SACE	Servizi Assicurativi del Commercio Estero (Italy)
SCI	Statement of Corporate Intent
SLA	service level agreement
SME	small and medium-sized enterprise
SoE	Statement of Expectations
STPF	structured trade and project finance
UNCAC	United Nations Convention against Corruption
WTO	World Trade Organization

Explanations

Billion	The convention used for a billion is a thousand million (10^9).
Findings	*Findings in the body of the report are paragraphs highlighted using italics, as this is.*
Recommendations	***Recommendations in the body of the report are highlighted using bold italics, as this is.***

OVERVIEW

Key points

- The Export Finance and Insurance Corporation (EFIC) has been established to facilitate and encourage Australian export trade through the provision of financial services. EFIC is expected to conduct its origination business (loans, guarantees, insurance) on a commercial basis. EFIC also manages the national interest account.
- Virtually all of Australia's exports, by volume and value, take place without EFIC's assistance. EFIC's support goes to relatively few firms and often on a repeat basis. By value most of the support is targeted to large corporate clients. These clients account for more than three quarters of the value of EFIC's signings in 2010-11.
- Over the past five years, EFIC has earned most of its income through the investment of surplus funds and its capital and reserves, not the provision of financial services. EFIC's commercial account operations have yielded a low rate of return, with some facilities subsidised by taxpayers.
- EFIC's commercial account objective should be to efficiently address the limited number of market failures that impede otherwise commercially viable export transactions.
- While few, if any, markets conform to the competitive ideal, there is no convincing evidence of systemic failures that impede access to finance for large firms or for resource-related projects in Australia.
  - EFIC should not continue to provide facilities to large corporate clients or for resource-related projects in Australia, including suppliers to those projects, on the commercial account.
- Financial markets may be affected by information-related failures. These are likely to be limited to small and medium-sized enterprises (SMEs) with limited export experience or attempting to access emerging export markets.
- Accordingly, EFIC's role should be to demonstrate to the private sector that providing export finance to such newly exporting SMEs can be commercially viable.
- To fulfil this demonstration role, EFIC should provide export finance services on the same basis as the private sector. This means:
  - setting prices to cover the expected full economic costs of provision; and
  - being subject to competitive neutrality arrangements, including earning an appropriate return on equity, setting prices commensurate with risk, and paying a tax-equivalent charge and a debt neutrality fee.
- EFIC's commercial account product range should normally be limited to guarantees, including the provision of bonds on behalf of the exporter.
  - When directed by the Minister, the product range may extend to reinsurance for a limited period, to cover sovereign and country risk insurance provided to newly exporting SMEs by the private sector, when financial markets in the buyer's country are temporarily disrupted.
- Measures should be introduced to enhance the transparency of EFIC's activities to the Minister, the Australian Government and the public.

Overview

What the Commission has been asked to do

The Productivity Commission has been asked to undertake a public inquiry into arrangements for the provision of export credit through Australia's export credit agency, the Export Finance and Insurance Corporation (EFIC). The terms of reference for this inquiry require the Commission to, among other things:

- review the rationale for government involvement in the provision of export finance and insurance
- assess EFIC's management of credit and funding risks
- review EFIC's pricing and service arrangements and assess their impact on incentives for Australian exporters to access private sector providers of export finance and insurance products
- review EFIC's exemption from competitive neutrality policy.

The Commission's approach to this inquiry is to consider the rationale for government provision of export finance and insurance through EFIC on the commercial and national interest accounts. In keeping with the *Productivity Commission Act 1998*, the Commission has taken an economy-wide perspective. This involves identifying if there is a market failure warranting intervention, determining the most appropriate form of intervention, and evaluating whether EFIC's activities and governance arrangements efficiently implement that intervention.

The Commission has followed its usual transparent and public processes, releasing an issues paper and a draft report for written comment, conducting public hearings and meeting with stakeholders. Feedback on the draft report, including material provided by EFIC, was drawn on in finalising this report with some findings and recommendations amended accordingly.

The Commission has undertaken economic analysis consistent with its terms of reference, basing its findings and recommendations on the evidence available. This economic analysis does not constitute a performance or compliance audit of EFIC's financial and legal affairs.

The Export Finance and Insurance Corporation

Australia has had an export credit agency (ECA) since the establishment of EFIC's predecessor, the Export Payments Insurance Corporation, in 1957. EFIC was established in its current form in 1991 under the *Export Finance and Insurance Corporation Act 1991* (EFIC Act) to facilitate and encourage Australian export trade through the provision of financial services (box 1).

The financial services EFIC offers include loans, guarantees and insurance products, and published information relevant to Australian exporters. Beneficiaries of EFIC's services include exporters and their suppliers, their buyers and financial intermediaries, subject to satisfying eligibility criteria specified in the EFIC Act. EFIC is able to provide financial services to firms located in Australia which contribute to the production of exports but do not themselves export. This has enabled EFIC to provide facilities to suppliers to resource-related projects located in Australia.

Box 1 **EFIC's functions and duties**

EFIC has the following functions under the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act) (s. 7):

- encourage and facilitate Australian export trade
- encourage banks and other financial institutions carrying on business in Australia to assist in financing export contracts
- manage the Australian Government's aid-supported loan program
- provide information and advice regarding insurance and financial products available to support Australian exports.

EFIC's duties under the EFIC Act (s. 8) include:

- improving and extending the range of financial services available to exporters
- complying with directions given by the Minister
- providing its services and products as efficiently and economically as possible.

The commercial account and the national interest account

EFIC operates using two accounts — the commercial account and the national interest account. The Minister cannot require EFIC to obtain ministerial approval for a particular transaction, or direct EFIC to enter into a particular transaction, on the commercial account. The Minister may direct EFIC more generally as to how it performs its functions under s. 9 of the EFIC Act.

(Continued next page)

Box 1 (continued)

The Minister can approve, or direct, transactions on the national interest account that are in the national interest, although by convention Cabinet approval is sought. EFIC is able to refer transactions to the national interest account for approval by the Minister. EFIC manages national interest account facilities through a service level agreement with the Department of Foreign Affairs and Trade. EFIC is reimbursed for any losses on the national interest account, remits any profits to the Australian Government and receives a fee for its administration.

EFIC's business operations

In 2009-10, EFIC provided 54 facilities to 41 exporting firms on the commercial account. About 45 000 firms exported goods and services in the same financial year.

EFIC's origination business provides loans, guarantees and insurance products under eligibility criteria specified in the EFIC Act. The origination business is further separated into a structured trade and project finance division that supports large corporate clients, and a small and medium-sized enterprises and mid-market division. A treasury function borrows on domestic and international capital markets, structures cash flows in Australian and foreign currencies, and manages EFIC's investment portfolio of capital and reserves. At 30 June 2011, EFIC had 85.8 full-time equivalent employees.

Key financial indicators

At 30 June 2011, EFIC's capital base was about $408 million of paid-in equity and retained earnings and $2.4 billion in debt. EFIC held $1.3 billion in liquid assets. The EFIC Act provides for EFIC's debt to be guaranteed by the Commonwealth, although this guarantee has never been called. EFIC has access to $200 million of callable capital payable by the Commonwealth.

Profits generated by EFIC are either retained to increase the size of its capital base or paid to the Australian Government as a dividend. EFIC has paid about $75 million in dividends over the period 2006-07 to 2009-10.

Ministerial Statement of Expectations

The Minister communicates expectations of the EFIC Board through the publicly released Statement of Expectations (SoE). A key requirement in the SoE is that EFIC is not to compete directly with commercial providers of finance, as this is the basis for EFIC's exemption from competitive neutrality arrangements, and the basis for EFIC's 'market gap' mandate.

The need for EFIC to fill a gap in the market was stated in the second reading speech when the EFIC Act was debated in Parliament. The market gap has been formally defined in the SoE 'as circumstances where the credit and insurance sectors are not able or are unwilling to provide credit and insurance services to financially viable Australian export transactions or overseas projects'.

EFIC's role in export finance and insurance markets

International trade typically takes place on the basis of cash or short-term credit, without intermediation through financial markets. For those firms that do require export finance and insurance, Australia has relatively deep and liquid financial markets and is recognised as a regional leader in finance and insurance. Finance and insurance is the largest sector in the Australian economy, accounting for about 10 per cent of GDP in 2010-11. Many importers and exporters can also access international markets for trade finance and insurance.

EFIC is a small ECA by global standards. While it is difficult to estimate the exact percentage of Australian exports assisted by EFIC on the commercial account, it is likely to be no more than a few per cent. Virtually all Australia's export trade, by volume and value, takes place without EFIC's assistance.

Government programs and services for exporters

In addition to the services provided by EFIC, the Australian, state and territory governments provide a range of financial and advisory products and services that directly assist exporters (box 2). The coverage of this assistance is highly concentrated in the manufacturing sector and only a fraction of exporters receive this assistance. There is also a number of Australian Government programs that offer financial assistance to businesses in general, including those involved in exporting. Receiving financial support from these programs does not preclude firms from accessing EFIC's financial services.

Box 2 **Government assistance to exporters**

In addition to EFIC's activities, government assistance to exporters is provided through:

- other Australian Government direct export assistance programs, including the Clean Energy Trade and Investment Strategy
- Austrade and Tourism Australia
- Australian Government general assistance programs to businesses that provide tariff concessions, training assistance, information and advice, and start-up assistance
- state and territory government initiatives including trade missions and direct financial assistance.

(Continued next page)

Box 2 (continued)

Australian Government *direct* financial assistance for exporters is estimated at $522 million in 2010-11. This does not include direct financial assistance provided through export-related programs by state and territory governments, or the value of general assistance programs that benefit exporters. Importantly, it does not include assistance by way of the Australian Government's Enhanced Project By-law Scheme (EPBS), which provides tariff duty concessions to large projects having an approved plan to use local suppliers.

Australian Government direct financial assistance that is specific to exporters comprises:

- the Export Market Development Grants (EMDG) scheme — businesses with annual turnover of up to $50 million can apply for up to seven grants to partly reimburse expenses incurred in promoting exports. Latest figures show about 95 per cent of recipients had annual turnover less than $20 million
- Tradex — provides a cashflow benefit for importers who intend to export goods by exempting them from the relevant duty at the time of import
- the Duty Drawback Scheme — enables businesses to obtain a refund of Customs duty paid on imported goods where those goods will be treated, processed, or incorporated into other goods for export, or are exported unused since importation.

Australian Government direct funding for export programs, 2010-11

$ million

Industry	*EMDG*	*Tradex*	*Duty Drawback*	*Total funding*
Primary industries	3.8	0.3	–	4.1
Mining	1.4	0.3	–	1.7
Manufacturing	47.6	33.9	74.5	155.9
Services industry groups	90.3	4.7	–	95.0
Total all industries	**143.1**	**39.2**	**74.5**	**256.7**

The Australian Government also provides general business support:

- Commercialisation Australia is a competitive, merit-based assistance program offering funding and resources to accelerate the business building process for eligible Australian companies and entrepreneurs.
- Supplier Access to Major Projects helps Australian industry participate in major Australian and international projects by providing funding to assist research and identification of capable Australian suppliers. The program is funded through the Department of Industry, Innovation, Science, Research and Tertiary Education (DIISRTE).

(Continued next page)

Box 2 (continued)

- Australian Industry Participation (AIP) Plans encourage the use of Australian industry in projects and global supply chains. Companies applying for large Commonwealth grants (generally above $20 million) or other schemes, are required to implement an AIP Plan and so provide opportunities for local suppliers. This requirement includes participants in the EPBS. About $230 million in tariff duty concessions was provided to project proponents, including a number of large resource projects, under the EPBS in 2010-11. The Commission was unable to ascertain the proportion of EPBS support provided to exporters.
- A range of research and development (R&D) tax concessions is available to eligible Australian companies. These programs include the R&D Tax Concession, Premium R&D Tax Concession, R&D Tax Offset, Venture Capital Limited Partnerships, Early Stage Venture Capital Limited Partnerships and Pooled Development Funds.
- There is a range of programs specifically directed at small start-ups and small and medium-sized enterprises (SMEs) that can be utilised by exporters, including:
  - the Small Business Support Line — an AusIndustry program to provide small business owners with a single point of contact to access information and referral services to help better manage their business
  - Enterprise Connect — a DIISRTE initiative that offers advice and support to eligible SMEs.

EFIC's operations on the 'commercial account'

EFIC's clients operate in a number of export sectors, including mining, manufacturing, construction, and ship building and operation (figure 1).

EFIC's recent transactions on the commercial account are characterised by:

- a focus on large corporate clients. More than three quarters of the value of EFIC's signings in 2010-11 were facilities provided to large corporate clients (defined by EFIC as having annual turnover greater than $150 million). EFIC provided 11 facilities to these clients, with a total face value of more than $450 million in 2010-11 (table 1)
- substantial support for large resource projects, and related infrastructure, located in Australia. In 2010-11, EFIC provided:
  - a US$100 million export finance guarantee to the Wiggins Island coal export terminal consortium for a $3 billion project to increase coal export capacity at the Port of Gladstone

– a US$270 million insurance policy to Brookfield Australia Pty Ltd for the Brookfield rail project to upgrade the rail line from Morawa to Geraldton

– a US$250 million export finance guarantee to the Santos liquefied natural gas project in Gladstone.

Figure 1 **Principal recipients of EFIC's facilities**

Face value of commercial account facilities, 30 June 2011

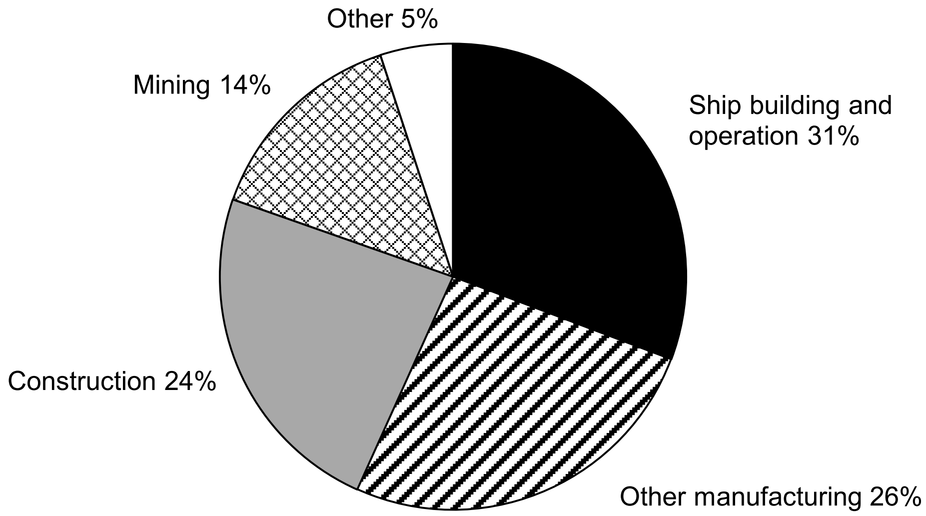


Table 1 **EFIC support for large corporate firms**

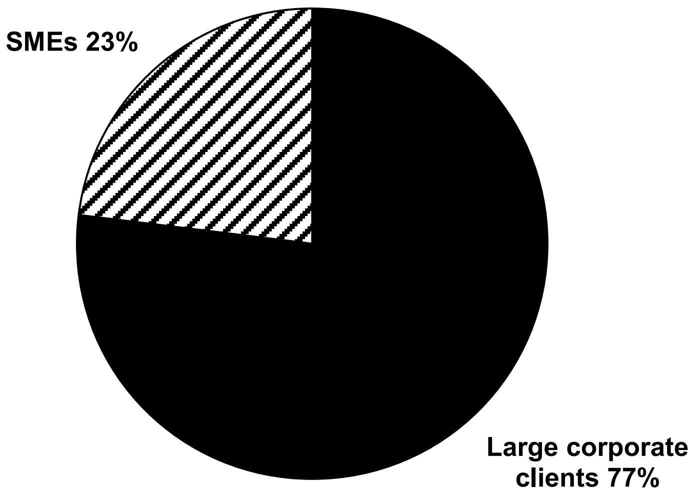
Commercial account, 2010-11

Underlying exporter	*Sector*	*Facility*	*Value (A$mil equiv)*
Leighton Asia (Northern)	Construction	Loan	76.7
Austal	Ship building	Loan	66.8
Leighton Holdings	Construction	Bonding line	50.0
UGL Limited	Construction	Bonding line	50.0
Brookfield Australian Investments	Construction	Bonding line	48.0
Incat Tasmania	Ship building	Loan	37.5
Anglo Coal Australia	Mining	Risk participation agreement	30.3
Transfield Services	Professional	Bonding line	30.0
Thornycroft Maritime & Associates	Professional	Export finance guarantee	25.5
McConnell Dowell Corporation	Construction	Bonding line	25.0
Clough Groups	Construction	Bonding line	16.6

During 2011-12, EFIC extended its activities to include support for suppliers to resource-related projects through the provision of bonds, bonding lines and guarantees. EFIC has disclosed its approval of six facilities located in Australia since 1 July 2011, with a total face value $128 million (in addition to the three resource-related projects above). EFIC confirmed at the public hearings that two of these facilities were provided to suppliers to resource-related projects. There is insufficient public information available about the remaining four facilities.

EFIC also assists small and medium-sized enterprises (SMEs) on the commercial account. In 2010-11, 90 facilities were signed with SMEs with a face value of about $135 million. Facilities with SMEs accounted for just over 20 per cent of the total face value of EFIC's commercial account signings that year (figure 2). In its 2011 annual report, EFIC noted strong demand for products typically used by SMEs, such as working capital guarantees.

Figure 2 **EFIC signings by business size**
As a proportion of total face value, commercial account, 2010-11



Rationale for government intervention in export finance

National interest objectives

Export credit agencies are established for a number of purposes, including meeting broader objectives of government in the 'national interest'. National interest arguments may include the delivery of foreign aid or meeting foreign policy objectives, such as regional stability and growth. For example, in 2009-10 the Australian Government granted a US$250 million loan on the national interest account for a liquefied natural gas project in Papua New Guinea.

The EFIC Board is able to refer a project to the national interest account for consideration by the Minister if it considers there is a high degree of country or project-related risks, or if the exposure would exceed EFIC's internal limits for the commercial account. Projects may also be jointly supported on the national interest and commercial accounts. Where support for a proposal is being sought on both accounts, the commercial account component should be supported by EFIC for commercial reasons only.

The Commission sees no reason at this time to change the arrangement between the Department of Foreign Affairs and Trade and EFIC to manage national interest account facilities after they have been approved by the Minister. An assessment of alternative arrangements should be included in the next independent review of EFIC to ensure current arrangements meet government objectives at least cost.

In the Commission's view, analysis of national interest account facilities should include an assessment of whether the proposal is the most cost-effective way of meeting the outcomes intended by the Australian Government. The Minister should publicly articulate the justification for a national interest account facility after its approval.

Market failure rationales for government intervention on the commercial account

Where markets — including financial markets — are well-functioning they promote efficiency by allocating resources to their highest value uses. Markets may be vulnerable to some forms of market failure (box 3) and few, if any, markets conform to the ideal of perfect competition.

A number of rationales for government intervention in export finance and insurance markets have been raised by inquiry participants and in some of the literature. These rationales include: increasing the level of exports produced in the economy to generate multiplier effects (including during financial crises to ameliorate any slump in international trade); alleviating cost and competition pressures for exporters; offsetting the activities of other countries' export promotion activities, including through their ECAs; and addressing perceived problems in financial markets that lead to a shortfall in the availability of finance and insurance.

Box 3 **Five sources of 'market failure'**

Externalities arise when the actions of an individual or firm create a benefit or a cost for others who are not a party to the transaction, and these impacts are not reflected in market prices.

Public goods arise where consumption of a good is non-rivalrous (consumption by one person does not affect the amount available to others) and non-excludable (people cannot be prevented from consuming the good). Producers and consumers cannot capture the full benefits of provision and payments for provision cannot be enforced. Consequently, public goods are likely to be under-provided by the private sector.

Inadequate information about a transaction can occur where there are institutional or cost barriers preventing parties to a transaction obtaining relevant information about the characteristics of a transaction (most notably risks) and/or each other. In such cases, market participants may adopt simplified decision rules based on a reduced set of information.

Information asymmetry arises where one of the parties knows more about key aspects of the transaction than the other. One possible consequence is 'adverse selection' — a bias toward entering into lower quality or higher risk transactions. Another potential problem is 'moral hazard', which occurs when a party modifies its behaviour after the transaction to exploit any information advantage.

Lack of effective competition may arise in the presence of market characteristics such as natural monopoly or when the market has a small number of firms that are able to restrict output and maintain prices above optimal levels. A small number of participants in the market, alone, is not evidence of the exercise of market power. The threat of new entrants may discourage the use of market power.

Any intervention through EFIC should generate net benefits to the economy

In order for government intervention to increase exports *and* generate net benefits to the economy, that intervention must target failures in financial markets that are impeding otherwise commercially viable export transactions in a way that generates a net benefit to the economy. Promoting exports *per se* will generally only shift domestic resources (labour and capital) away from more profitable activities and potentially drive down prices of the exports (benefiting foreign buyers). This would reduce, rather than increase, Australia's aggregate income.

However, government intervention in markets is never perfect and the cost of particular interventions will generally need to be weighed against their benefits. Government policies can distort market outcomes where, for example, poorly designed regulation increases the cost of supply of export finance and insurance and prevents some transactions from happening altogether.

The Commission has undertaken an evaluation of EFIC's operations on the commercial account to determine whether they are consistent with a market failure rationale for government intervention.

Do EFIC's operations address market failures?

Support for large resource projects located in Australia

EFIC has extended its operations to the provision of financial services to firms undertaking resource projects and related infrastructure (box 4), and to domestic firms supplying goods and services to those projects, including Greyhound Australia (box 5).

Box 4 **Brookfield rail upgrade – market failure or company policy?**

In early 2011, Brookfield Rail commenced an upgrade of the rail infrastructure between Geraldton and an iron ore mine located in Karara, Western Australia. The mine is a joint venture between Gindalbie Metals and Chinese company, Ansteel. The rail infrastructure is part of the general rail system in the mid-west of Western Australia, formerly operated by the Western Australian Government.

EFIC disclosed its involvement in the upgrade in the second half of 2011.

EFIC has provided a US$270 million insurance policy to Brookfield Australia Pty Ltd for the Brookfield rail upgrade project. The purpose of the facility is to insure the credit risk on a letter of credit issued by a AA- rated bank owned by the Chinese government.

More than half of the facility will be reinsured by another export credit agency.

Brookfield Rail is a wholly owned subsidiary of Brookfield Infrastructure Partners L.P., a company with extensive worldwide operations. The company's other interests include European ports, Canadian freehold timberlands and US electricity transmission. The parent company, Brookfield Asset Management, is listed on the Toronto and New York Stock Exchanges, and in 2007 acquired Australian construction firm Multiplex.

In the year ending 31 December 2011, Brookfield Infrastructure Partners L.P. reported a net income of US$440 million, and had more than US$13 billion in assets.

Brookfield Australia Pty Ltd noted in its submission to the Commission, 'there was no obligation on Brookfield Rail, regulatory or otherwise, to invest in the track upgrade unless it determined the commercial rationale warranted the investment and the assumption of associated risks'. That is, Brookfield Rail entered into the rail upgrade project based on commercial returns to the company.

(Continued next page)

Box 4 (continued)

The submission further noted EFIC's support was sought because 'Brookfield Rail was required to secure additional debt financing in order for the investment program to provide the return profile required to warrant the investment of equity by its parent'. EFIC's submission to the draft report noted that Brookfield Rail and its lenders were unprepared to accept the risk of a government owned Chinese bank without risk mitigation in place. Rather than EFIC's involvement being driven by a failure in financial markets, it was the company's internal policy that determined more debt was needed and, in turn, Brookfield Rail's lenders who determined that insurance was needed to enable the investment to go ahead.

Submissions to this inquiry asserted that EFIC's assistance for resource-related projects located in Australia was required to overcome a shortfall of capital for projects across the infrastructure, energy and mining sectors. The Australian Chamber of Commerce and Industry argued that EFIC's provision of services for larger transactions and companies is justified on the basis that smaller companies can 'coat tail' large scale projects as suppliers.

EFIC argued in its submission responding to the draft report:

> In the current circumstances in which Australia finds itself, of an historically unprecedented resource investment boom and impaired markets for cross-border project and structured trade finance, EFIC's retreat from onshore financing would imply slower resource investment and slower subsequent export growth. Contrary to the Commission's view, such deferred investment and exporting would not be a case of the market denying resources to uncommercial projects in the interests of efficient resource allocation. It would rather represent a sacrifice of real economic opportunity in the near term.

Box 5 **Should EFIC have supported Greyhound Australia?**

In 2012, EFIC provided a $5 million performance bond on behalf of Greyhound Australia for it to meet the terms of a $105 million contract to provide transport services for a mining operation at Wheatstone in Western Australia. The facility is one of the first under a new initiative to serve suppliers contributing to the production of exports but who themselves do not export. Under the initiative, suppliers 'must form an integral part of the overall resource export project' to be eligible for EFIC's support. Eligible suppliers can apply to EFIC for bank guarantees, working capital support and longer-term finance.

(Continued next page)

Box 5 (continued)

A market gap?

The 'market gap' identified by EFIC was the unwillingness of Greyhound Australia's bankers (including ANZ which is also the company's former majority shareholder) to provide a bond with less than full-cash cover. This was despite Greyhound Australia's long history in the coach industry, its financial restructure and its other contracts to service mining operations. At public hearings EFIC stated:

> The performance bond is for six years. There is no bank in Australia that is willing to take risk on Greyhound for six years. There is just not the slightest question about it. What EFIC has done is provide that bond to Greyhound to enable it to win business.

Greyhound Australia's inability to source a performance bond with less than full-cash cover may in part stem from its financial situation — an insolvency and turnaround advisory firm was appointed by ANZ to restructure the company in 2006 and in recent times, Greyhound Australia has undertaken a review of its business strategy.

An inability to source a financial product because of a firm's particular financial situation does not constitute a market failure. A range of alternatives may have arisen if EFIC had not provided a performance bond. For example, Greyhound Australia may either have renegotiated the terms of service, provided a bond with full-cash cover or the contract may have been awarded to another firm. In fact, EFIC's actions precluded those outcomes. It stated:

> We gave them the financial support they needed to ensure that they won that business and it couldn't go elsewhere.

Local content?

Information provided to the Commission by EFIC indicates Greyhound Australia was the preferred tenderer over a number of Australian competing tenderers, and one with foreign ownership. When assessing Greyhound Australia's application for the performance bond, EFIC did not seek to confirm which firm was the next preferred tenderer. This was despite stating at public hearings: 'what is important is the Australian content component, and this is why this initiative has been started'. EFIC's focus was on Greyhound Australia's ability to proceed with the contract, and less so on whether its support for Greyhound disadvantaged local competitors.

Relationship to exports?

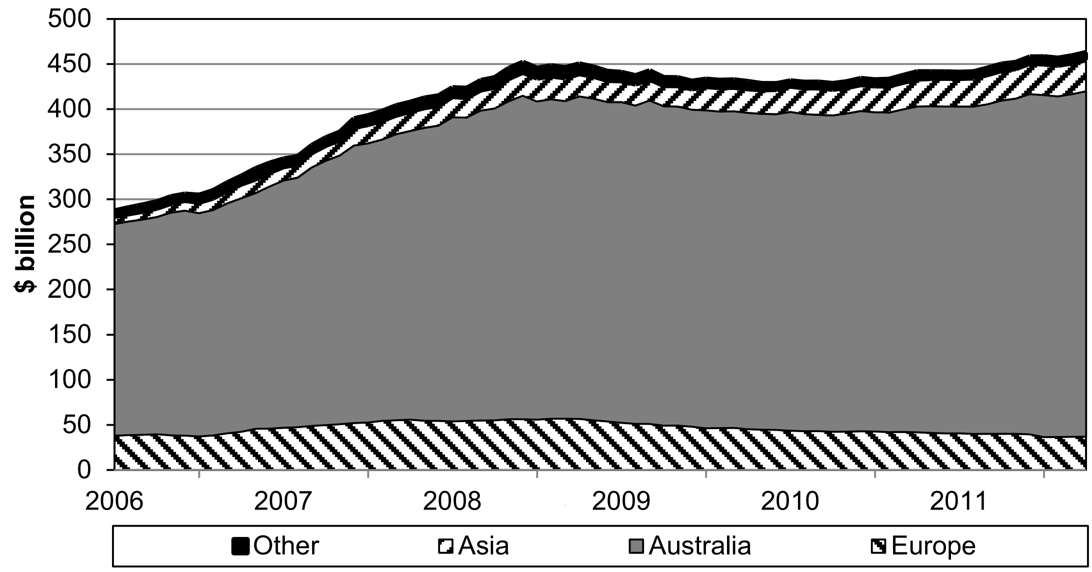
At public hearings, EFIC was also unable to present a clear rationale as to why coach operators servicing domestic resource projects should be eligible for assistance when other suppliers, such as cleaners and caterers, are not. In assisting Greyhound Australia, EFIC has adopted a very broad definition of exports, a precedent bringing a significant risk that it will continue to extend its activities where no market failures are present.

An imbalance between demand for, and supply of, capital is not a market failure — this happens in all markets. Balance is typically restored over time through changes in the market price. The Commission has found no convincing evidence to indicate there are regulatory or other barriers that impede access to debt or equity finance for large firms, or resource and infrastructure projects located in Australia that would justify EFIC's involvement.

The Commission also found:

- Following a dip during the global financial crisis (GFC), lending by banks to non-financial corporations has returned to pre-GFC levels. While the volume of lending by European domiciled banks in Australia has declined, this has been more than offset by increased lending by Australian and Asian domiciled banks (figure 3). Australian firms also continue to access debt and equity in domestic and international markets, although finance may be more expensive than was the case prior to the GFC.
- Private sector investment in infrastructure over the past 10 years has nearly doubled. Investment in the mining sector, although declining slightly in 2009-10 following the GFC, has recovered to be about 20 per cent higher than its 2008-09 value.

Figure 3 **Volume of lending has returned to pre-GFC levels**



In short, it is not evident to the Commission that there are market failures affecting the provision of capital to resource projects in Australia, and related infrastructure, that require intervention by the Australian Government through EFIC.

EFIC's large corporate clients have options to secure finance elsewhere

EFIC's commercial account activity is largely focused on large corporate clients — many of these are publicly listed companies and some have global operations. In recent years, many of EFIC's large clients have successfully raised finance in private debt and equity markets. This has included raising private debt with tenor (the term of the facility) of 10 years or longer. Further, several of EFIC's large corporate clients reported strong financial positions and were optimistic in their annual reports about their ability to fund future investments.

EFIC's provision of export finance and insurance to these firms cannot be justified on the basis of failures in financial markets, since these firms are able to access other (albeit possibly more costly) sources of capital. Alternatively, it may be the case that other sources of finance were not available for any of a number of commercial reasons related to the characteristics of the proposed project or export transaction.

The export supply chain — no evidence of market failure

In supporting resource-related projects located in Australia, including suppliers to those projects, EFIC has moved beyond what is necessary to address any market failures affecting exporters' access to export finance or insurance. EFIC's support for Greyhound Australia, for example, was not based on a market failure — EFIC stated it stepped in to *ensure* Greyhound Australia was able to win the contract to supply transport services for mining staff, when the firm's banks were not willing to provide a performance bond on terms acceptable to Greyhound Australia. It is possible a more efficient firm would have provided the transport services if EFIC had not intervened.

International financial crises — can EFIC cushion a slump in exports?

Inquiry participants, including EFIC, argued that significant market disruptions, such as the GFC, justify government intervention through ECAs to at least partially offset any slump in exports due to a tightening of credit markets. However, surveys have shown that the decline in the provision of trade finance during the GFC was primarily due to lower levels of international trade and resulting lower demand for trade finance products. The behaviour of financial institutions, including ECAs, was less important relative to changes in demand. In the Commission's view, providing export finance and insurance with the aim of ameliorating the decline in international trade would have been unsuccessful and does not represent a sound rationale for EFIC's future involvement in financial markets.

A ‘market gap’ is not necessarily a market *failure*

EFIC’s market gap mandate is meant to constrain its activities to parts of the market that are not served by the private sector, thereby seeking to ensure it complements, rather than competes with, private sector providers. For the most part, the private sector appears to offer the same types of products as those offered by EFIC (although this does not mean they are offered in all markets, such as those with high sovereign risk). However, the terms and conditions, including price, at which EFIC offers these products may be different to that of the private sector. EFIC stated in its submission to the Commission’s Issues Paper that one of the reasons clients seek their support is that EFIC is able to assist with long-term financing arrangements beyond the capacity of the private market.

Capital, like other resources, is scarce. As a result, private sector providers will seek to finance or insure those transactions with the highest rate of expected return. In financial markets, scarcity of capital means that exporters must pay more to secure finance or insurance for higher risk transactions — such as those with long tenor — than for low risk transactions. As a result, higher risk transactions will not go ahead where the cost of financing or insuring those transactions makes the transaction commercially unviable. This is not a market failure, but an essential feature of efficient financial markets that is consistent with prudent financial management.

A call for EFIC’s assistance is not evidence of failures in financial markets

Participants to this inquiry have presented evidence to the Commission to support EFIC’s assistance to firms in circumstances that are not market failures (box 6). In some instances, calls for EFIC’s assistance are based on private decisions about preferred business models and a firms’ risk preferences, rather than failures in financial markets. Challenges in securing finance for large projects are not of themselves an indication of market failure or other systemic problems with the capital market generally, or in relation to any given sector. The concerns reported in submissions are typically about the finance terms and conditions. Similarly, overcoming any market distortions caused by other ECAs is not sufficient to justify government intervention through EFIC. Australia is unlikely to be able to drive change in the policies of other ECAs. Attempting to do so through EFIC offering subsidised facilities is likely to be counter-productive.

Box 6 **Many calls for EFIC's assistance are not based on market failures**

Inquiry participants, including EFIC, its clients and private sector providers of export finance and insurance discussed the role that EFIC was performing in financial markets:

- Thiess Pty Ltd argued that it needed EFIC's support to implement its growth strategy in the current financial environment:

  As part of our growth strategy, Thiess has leveraged the technical and operational strengths of its domestic operations into international markets. This strategy requires funding, bonding and insurance lines which, given current global economic circumstances, can be challenging to source through private sector institutions. Continuation of our growth is therefore connected to a reversal of private sector trends in risk and credit, and support from the [export credit agencies].

- According to EFIC, Leighton Holdings 'turned to EFIC for assistance when it reached its approved offshore leasing limits with its banks'.
- Marine Western Australia Inc. argued that EFIC's involvement was a form of assistance to overcome cost pressures faced by the ship building industry:

  In today's climate probably the biggest impediment to shipbuilding is the height of the Australian dollar … the name of [the assistance program] … or the agency is not as important as the actual assistance ...

- In justifying the need for repeat business with Shark Bay Salt, EFIC observed:

  The cost to the exporter of moving to another bank was prohibitive due to 'switching costs' and without switching, other banks would have little incentive to support a 'one-off' (relatively small) export transaction.

- Wiggins Island Coal Export Terminal Pty Ltd observed:

  EFIC's involvement from April 2011 and final commitment in September 2011 was a critical component for WICET being able to complete the financing. WICET's mandate could have been withdrawn by the Queensland Government had Financial Close not been achieved within the State's timeframe.

- According to Brookfield Australia Pty Ltd, an insurance policy provided by EFIC (box 4) was required to secure additional debt financing in order for the investment program 'to provide the return profile required to warrant the investment of equity by its parent'.
- When questioned whether it would consider finding other equity partners, Bronx International Pty Ltd considered it would only happen 'if we wanted to diversify into a different sort of business'.

(Continued next page)

Box 6 (continued)

- EFIC has provided facilities to Santos to develop liquefied natural gas projects in Papua New Guinea and Australia. In a 2011 press release, Santos stated that ECA facilities are a part of Santos' funding strategy. In defending its assessment of the market gap, EFIC noted:

  Santos is also funding the development of the PNG LNG project in which it has a 13.5 per cent interest, in addition to the large scale, existing operations in Australia and offshore, which require constant development and maintenance expenditure.

- In response to the Commission's draft findings and recommendations, the ANZ stated:

  It is open to the government to … leave the funding gap to foreign ECAs. However, those ECAs will be pursuing their own national interest. In most cases this means insisting on foreign equity in Australian projects and/or that the projects import goods and services from outside of Australia.

These are not examples of market failure. In some cases, calls for assistance have arisen from a firm's decision to enter into export contracts or projects that private sector providers consider commercially unattractive due, for example, to the size of the transaction or the firm's other financial exposures. In other cases, EFIC has provided assistance because the firm is reluctant to seek alternative sources of finance, including equity, or the firm is seeking to meet its internal risk management policies.

In sum, while few if any markets conform to the competitive ideal, there is no convincing evidence of systemic failures in financial markets that impede access to finance for large firms, or for proponents of resource-related projects and their suppliers. Any intervention in financial markets through EFIC to ameliorate declines in international trade is likely to be unsuccessful.

That said, there may be some instances of information-related failures in financial markets that may impede or prevent otherwise commercially viable export transactions. The Commission's proposed changes to EFIC's mandate and governance arrangements to align its operations with these potential market failures are discussed in later sections.

EFIC's assistance creates 'distortions' where there are no market failures

The market gap concept is not sufficient to ensure that EFIC's activities are addressing inefficiencies in financial markets caused by market failure. If EFIC is supporting firms where no market failure is present, then public funds are crowding out private funds in the financing of a project or export transaction, and risk is unnecessarily transferred to taxpayers. In addition, EFIC's support may enable a less efficient firm to prevail over a more efficient competitor.

In the Commission's view, EFIC's support for projects such as the Wiggins Island coal export terminal and the Brookfield rail upgrade in Western Australia was not based — and could not be justified — on a market failure rationale for government intervention.

In its submission to this inquiry Wiggins Island Coal Export Terminal Pty Ltd, the owners of the coal terminal assets, stated that this project 'would not have proceeded at that time without the support of [export credit agencies and government supported financiers]'. The submission further stated 'WICET's mandate could have been withdrawn by the Queensland Government had Financial Close not been achieved within the State's timeframe'.

The fact that some projects may be postponed because they are unable to secure finance is not necessarily indicative of a market failure. It may be that market participants require more information about a project before committing, or that the project is not commercially viable *at this time*. As capital is scarce, EFIC's support for a project where there is no market failure will have the dual effect of encouraging a greater level of investment than is efficient in areas that receive EFIC's assistance, and the drawing of resources away from more productive uses, including parts of the economy that are export-oriented.

EFIC's relatively small size limits the economy-wide consequences of such distortions. However, some of EFIC's facilities are of sufficient magnitude to pose non-trivial financial risks to the Commonwealth. These risks would be increased significantly if the Australian Government were to accept the proposition advocated by Citibank and the ANZ to increase EFIC's maximum exposure limit per transaction. Citibank, for example, noted that other ECAs can have financial exposure to a single transaction of greater than $500 million.

Is EFIC crowding out?

In the Commission's assessment, some of EFIC's activities have a crowding out effect that is distorting the allocation of resources within the economy, and this has detracted from its performance. EFIC may crowd out other providers of export finance and insurance, other sources of capital, alternative projects that may have been undertaken by clients, and domestic firms competing with the firm EFIC is assisting. EFIC's participation in financial markets where market failure is not present will also entrench the status quo of EFIC's support, preventing the development of private sector capacity to provide export finance and insurance.

That some of EFIC's activities are crowding out follows from the reality that the market gap mandate is not sufficient to ensure that EFIC will only intervene to support welfare-enhancing projects or export transactions that are impeded by failures in financial markets.

Equity effects and resource allocation

When EFIC intervenes and enables a project or export transaction to proceed that would not have otherwise done so, the exporting company, its workers, and associated industries will benefit by being able to produce and sell more output for export. Where private sector providers of finance and insurance are involved in the transaction, they also share in the benefits of EFIC's participation.

The beneficiaries of EFIC's assistance are relatively few — it services only a small number of Australia's 45 000 exporting firms. However, because EFIC is distorting the allocation of resources in the economy, the costs are widespread and include those borne by domestic competitors of EFIC's clients and, more broadly, the taxpayer.

EFIC and exporters — incentives for repeat facilities

EFIC has a relatively small client base, but a high proportion are repeat users of its services — more than 20 times in the case of one salt producer (box 7). The nature of such financial assistance to firms suggests there may be little incentive for some exporters (or private sector financiers) to change their business models. If the provision of export finance can be undertaken on a commercial basis, then the private sector should be willing to take on those transactions. If EFIC's financial services are not provided on a commercial basis, then the firms may be subsidised and the incentive to improve firm level efficiency is dulled. It also means that private providers cannot compete on the same terms.

EFIC and private sector providers

EFIC often conducts business with an exporter in conjunction with another intermediary (usually the exporter's or buyer's bank). EFIC noted in its most recent annual report that its support of finance and insurance providers is a core part of its functions:

> One of EFIC's functions is to encourage banks, other financiers and insurers to support exports and overseas investments. Our participation in larger transactions can often encourage private financiers to share the risks involved.

Some private sector providers, including the ANZ, the Commonwealth Bank and Westpac, have formal partnership arrangements with EFIC. Private sector providers benefit directly from EFIC's involvement in transactions through risk transfer from the provider to EFIC and from earning higher returns.

Box 7 One salt producer's multiple credit guarantees

EFIC has provided a salt producer, Shark Bay Salt, with more than 20 documentary credit guarantees for salt exports to Indonesia since 2009-10.

In its submission to the draft report, EFIC stated it provided the support because Shark Bay Salt's Australian bank could not confirm letters of credit due to its internal counterparty and country limits on Indonesia. Moreover, it stated that the cost to Shark Bay Salt of moving to another bank was prohibitive.

EFIC has not provided any support to Shark Bay Salt's Australian competitors, yet the majority of salt production is exported in bulk from northern Western Australia — a large share of this salt is exported to South East Asia, including Indonesia.

Three points arise from this example:

- There is no inherent need for EFIC to assist Shark Bay Salt, demonstrated by other salt producers being able to export without this assistance.
- EFIC's support allows Shark Bay Salt to avoid the business costs of switching banks — giving it an advantage against competing salt producers.
- EFIC's support lowers the cost to the bank of meeting its internal prudential policies.

In some cases, this relationship is built into a bank's business model. The ANZ, for example, lists structured export finance in partnership with ECAs as part of its products package and states that this partnership gives their clients 'access to an additional source of competitively priced, long-term debt for major capital and infrastructure projects'.

However, this indicates that there is an incentive for financial institutions to develop their business models based on the presence of ECA support, rather than developing their business models to *replace* ECA (or in this case EFIC) support.

Clients and partners support EFIC

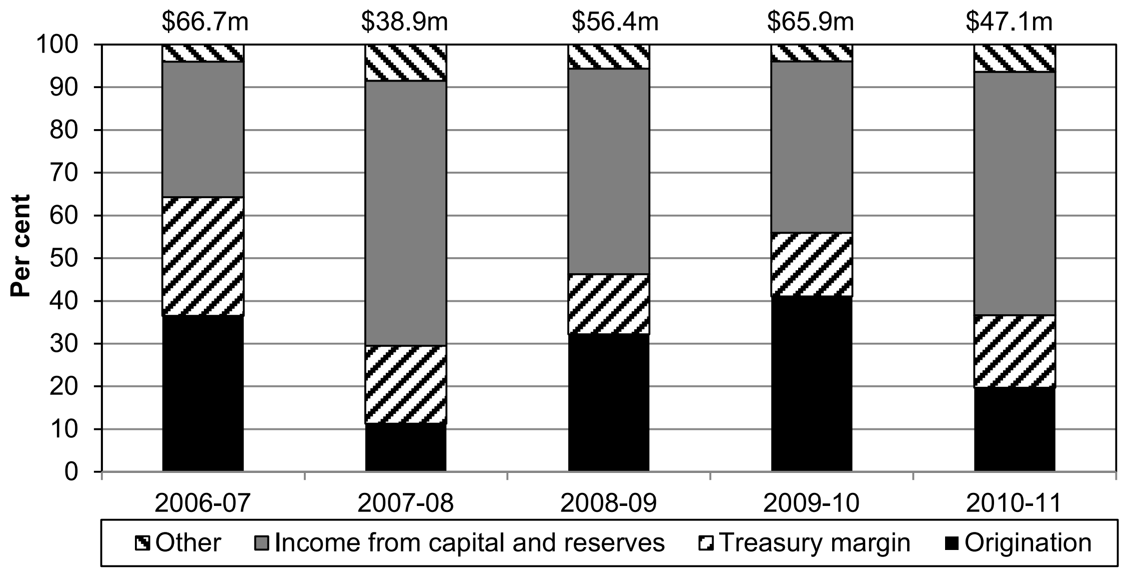
The Commission has received submissions from EFIC's clients and financial sector partners indicating their support for EFIC's services. It is not unusual that supported firms, or their representatives, put forward arguments for continued government intervention that improves their returns or reduces their risks. Similar arguments were used against the dismantling of import tariffs.

EFIC's financial management and performance

EFIC earns more income from investing its capital than from providing financial services to exporters

The primary reason for the establishment of EFIC is to provide export finance and insurance services. However, the origination business (box 1) has accounted for less than half of EFIC's income in each of the past five years (figure 4). The majority of EFIC's income is generated through the investment of its capital and reserves and the interest margin between its borrowings and investment of surplus funds (the treasury margin).

Figure 4 **EFIC earns less than half of its income through origination**



EFIC is able to borrow cheaply on domestic and international capital markets using its statutory government guarantee (currently AAA) and invest those funds in higher returning securities and deposits. At 30 June 2011, EFIC had $1.3 billion of liquid assets, where its capital and reserves, surplus liquidity portfolio and market recognition portfolios are invested. This is more liquidity than it needs to meet the requirements of its prudential management policies.

The Australian Government made an allowance for a special dividend of $200 million to be paid from EFIC's capital and reserves in the 2012-13 Budget.

Management of capital

EFIC maintains capital well above the prudential minimums established by the Australian Prudential Regulation Authority for other financial institutions and EFIC's internal minimums. This explains why EFIC's total income is dominated by income from investing its capital and reserves. As a wholly government owned entity, EFIC does not face the same incentive to productively manage capital as a private sector firm.

The size of EFIC's treasury operations and its capital requirements should be commensurate with the size and product offering of the origination business it supports. The Commission's view is that EFIC's treasury operations, liquidity and capital needs, and dividend policy should be subject to regular review by The Treasury and the Department of Finance and Deregulation.

Risk management

In 2010, Standard & Poor's found that EFIC's commercial account exposure (excluding political risk insurance and reinsurance) was consistent with counterparty risk of about BBB, the same as Bank of Queensland's long term credit rating.

Despite this, EFIC has at times had high exposure to particular sectors, parties and countries. For example, at its peak in 2007, EFIC's gross commercial account exposure to ship building and operation was 56 per cent of the total exposure on that account. EFIC's exposure to ship building and operation, excluding sovereign and semi-sovereign exposures and reinsurance, was about 36 per cent of total exposures between 2005 and 2007.

In 2010, EFIC's internal auditors observed that EFIC had large exposures to some countries, such as Zambia and Sri Lanka, and to ship building and operation. The auditors recommended that EFIC consider enhanced 'stress testing' and scenario analysis tailored to country and industry specific risks. On the basis of the material presented by EFIC, the Commission understands that this recommendation was not adopted.

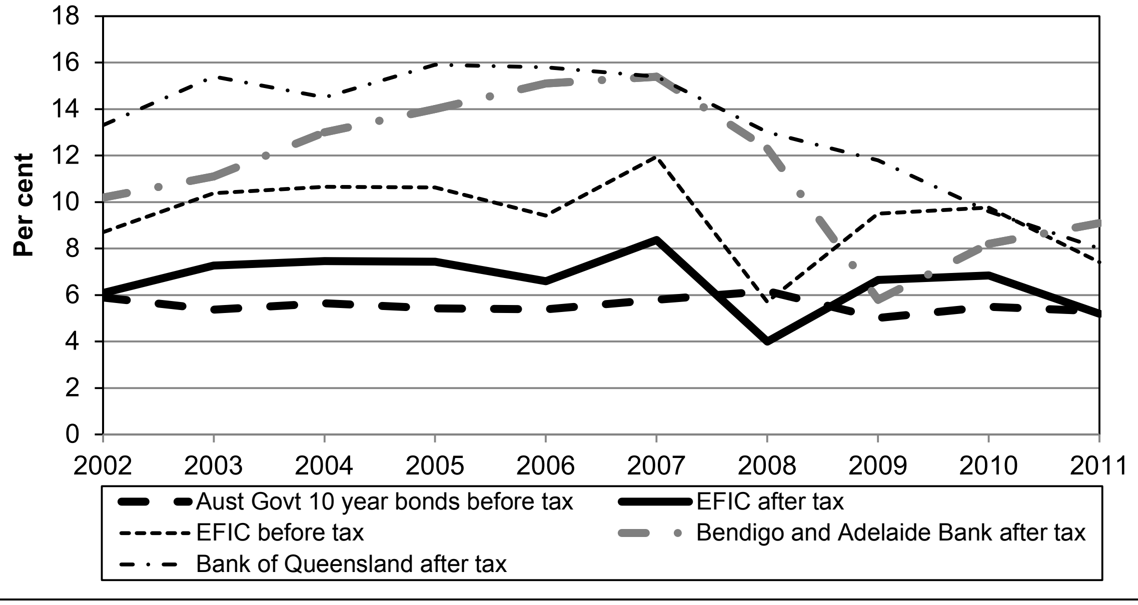
EFIC's high exposure to certain countries and industries, which drew the attention of the EFIC Board and the internal auditors, indicates that some aspects of its credit risk management have not always been sufficiently robust. In the Commission's view, it is important that EFIC revise its risk management policies to include a limit on exposures to particular industries.

Is EFIC operating on a commercial basis?

EFIC has reported modest accounting profits in 19 of the past 20 years. However, this is not sufficient to conclude that EFIC is operating on a commercial basis (or that it is generating a net benefit to the economy). Further, EFIC's exemption from competitive neutrality arrangements means that its accounting profits do not take into account the expected full economic cost of providing financial services, including income tax expense, lower borrowing costs and the opportunity cost of capital.

EFIC's return on equity was higher than the Australian Government's ten year bond rate over the past 10 years (figure 5). However, the return on Australian Government bonds (considered low risk given the Australian Government's AAA credit rating) does not represent an adequate benchmark for EFIC's financial performance, given the risk EFIC incurs on the commercial account. EFIC's low rate of return on equity indicates the Australian Government has not received an adequate return for the risk it has incurred from EFIC's operations.

Figure 5 **EFIC's financial performance — low returns to government equity**



In its submission to the draft report, EFIC stated that its return on equity reflects its concentration risks — a function of the niche in which it is required to operate — and this lowers gearing and return on equity. The Commission does not consider that a market failure (or even a market gap) mandate requires EFIC to deliver low returns to the Australian Government's equity investment.

Is EFIC subsidising the provision of export finance and insurance?

EFIC has stated that it does not provide subsidised finance, but applies commercial principles with prices that reflect risk. However, EFIC's pricing strategies do not ensure that all facilities are priced to earn a commercial rate of return on equity. This means EFIC's expected income from some facilities does not cover the expected full economic costs of providing export finance and insurance, including the opportunity cost of capital. These facilities are effectively being subsidised in advance by taxpayers.

Where a facility is subsidised, the subsidy will likely be shared between exporters, buyers, and other providers that are party to the transaction (including the private sector or other ECAs). It will almost certainly be the case that the exporter will receive a share of any subsidy — the size of the share will depend on the characteristics of the market and how the production and consumption of the exported good or service changes as price changes.

A future role for EFIC — addressing information-related market failures

EFIC's operations on the commercial account should be reoriented to addressing market failures that affect newly exporting SMEs seeking to access export finance. The Commission's proposed role for EFIC will require significant changes to its mandate, scope of operations and governance arrangements.

There are two information-related market failures that may warrant government intervention through EFIC on the commercial account, albeit on a more limited basis than at present:

- Problems may arise where private sector providers adopt simplified decision rules to lower transaction costs that may lead to the rejection of commercially viable export transactions.
- Markets may be 'missing' due to a temporary information failure relating to country or sovereign risks in the buyer's country. This may occur through severe disruption to financial markets. For example, civil unrest in countries, such as Sri Lanka or Iraq, may temporarily reduce the ability of private sector providers to properly calculate the risk of an export transaction.

These two potential information-related market failures may prevent commercially viable export transactions from proceeding.

Does EFIC have advantages in addressing information-related market failures?

EFIC may be able to help overcome information-related market failures, where they occur, through a demonstration effect for private sector providers. To achieve this, the Commission proposes that, following approval, EFIC release information about a facility to the market to enable private sector participants to judge over time the viability of servicing SME and similar clients. This approach may have advantages over mere information dissemination — the credibility of the generated information may be higher because of greater financial consequences to EFIC of making a mistake.

EFIC has experience in providing assistance to SMEs, including those seeking to access emerging export markets (box 8) and a capacity to adapt its services to the needs of SME clientele — several SME participants commented that EFIC provided them with guarantees and bonds that could not be sourced from the private sector. EFIC also has skilled staff (a point noted by several inquiry participants) and well-established relationships with private sector providers that would reduce its transaction costs in performing a demonstration role.

Box 8 **EFIC's assistance to a small and medium-sized enterprise**

EFIC's assistance enabled Environment Systems & Services (ES&S) to access additional working capital to fulfil export contracts for the provision of meteorological and geotechnical equipment in Asia and the Pacific region. EFIC provided an export working capital guarantee to the company's bank, the ANZ, enabling the bank to lend the same amount to ES&S. The additional working capital helped ES&S bridge the time difference between incurring costs and receiving payment from their clients. In a submission to this inquiry, ES&S indicated that the exports concerned would not have gone ahead without EFIC's assistance.

Pricing EFIC's facilities on commercial terms

For EFIC to efficiently address any potential information-related market failures, it must acquire information on the export transaction at a cost no greater than private sector providers, or charge accordingly. EFIC's business model would also need to be consistent with a demonstration role. If it is to show that providing export finance to exporting SMEs can be commercially viable, it should do so on the same basis as the private sector, with price covering the expected cost of provision.

This means EFIC should be subject to competitive neutrality arrangements, including earning an appropriately benchmarked rate of return on equity, setting prices that are commensurate with the level of risk undertaken, and paying a tax-equivalent charge and a debt neutrality fee. Put another way, if demand for EFIC's services occurs only because those services are subsidised, this would indicate that the export transactions are *not* commercially viable.

Aligning EFIC's operations to a demonstration role

A reorientation of EFIC's mandate toward a demonstration role focusing on newly exporting SMEs will require changes to the scope of EFIC's operations to service those firms where it is most likely that the intervention in financial markets will generate benefits to the Australian community.

EFIC's definition of an SME as a firm with annual turnover of up to $150 million encompasses substantial firms whose challenges in securing financial services are not the result of market failures that should be corrected by government intervention through EFIC. The Minister should amend the Statement of Expectations to require EFIC to define a small and medium-sized enterprise as an entity, including any related entities, with fewer than 100 full-time equivalent employees or annual turnover of less than $50 million.

EFIC's recent expansion of its operations to include support for suppliers to resource-related projects is problematic. It is based on provisions of the EFIC Act that are very broad, conceivably covering any transaction in the export supply chain (box 5). This creates the risk of EFIC supporting projects and firms that are increasingly remote from the original export focus of the EFIC Act, and from market failures affecting exporters' access to finance or insurance. There is a risk that, through its expansion into those areas, EFIC will provide assistance to those that do not require it or to less efficient firms that do, while acquiring the focus and characteristics of an investment bank. To remove this risk, the EFIC Act should be amended to remove all references to EFIC providing support to those indirectly involved in Australian export trade.

Further, EFIC's operations should be targeted at information-related market failures that are impeding otherwise commercially viable transactions that directly relate to the export of goods and services from Australia. For this reason, EFIC facilities that are provided on the commercial account should be limited to transactions that are based on an export contract as defined in the EFIC Act.

Improving EFIC's governance arrangements

Clarity of purpose

Clear objectives are essential for establishing an organisation's priorities, and are the basis for holding it accountable for its performance. EFIC is currently required to perform its functions only in circumstances where the private sector is not able or willing to provide credit and insurance services to financially viable export transactions. At the same time, there is an expectation that EFIC's commercial account operations are to be conducted on a commercial basis — although a specific performance measure to assess whether EFIC is meeting this expectation, such as a target rate of return on equity, has not been set by the Australian Government.

A need for more transparency

EFIC has some of the building blocks for a strong governance framework, such as a merit-based board with members who have experience in managing financial institutions. However, some of EFIC's internal governance processes are weak. For example, the Commission has found that facilities to support suppliers to resource-related projects in Australia have been approved without adequate eligibility criteria to determine whether the good or service provided is integral to the ultimate goods produced for export.

EFIC's governance practices, including its internal audit program, are not sufficient to ensure that its activities are consistent with the operational restrictions set out in the Statement of Expectations and Part 4 of the EFIC Act. Further, there is a lack of clarity in the information it provides to the Australian Government, and to the public, and this impairs EFIC's accountability.

EFIC should be required to publicly release its corporate plan and publicly report against a performance management framework. It should also inform the Minister about commercial account transactions after they have been approved.

A number of submissions to this inquiry raised concerns about the environmental and social consequences of EFIC's operations, and EFIC's disclosure practices. EFIC should be required to release more information relevant to environmental and social impact assessment, and the Australian Government should remove EFIC's special exemption from the *Freedom of Information Act 1982* (while retaining protection for Cabinet and commercial-in-confidence material).

Assessing the need for ongoing assistance to newly exporting SMEs

EFIC's operations on the commercial account at present are poorly directed and inequitable. A focus on the so-called 'market gap' has meant that EFIC has not targeted its operations to address market failures, but rather to areas that should be the domain of the private sector. EFIC's pricing and project selection criteria distort the allocation of resources within the trade finance sector and within the economy, and these distortions would be magnified with any expansion of EFIC's commercial account operations.

The reforms to EFIC's mandate and operations recommended in this report seek to reorient EFIC's operations to address information-related market failures confronting SMEs and to improve EFIC's governance arrangements. The Commission's proposed reforms are summarised in table 2.

EFIC's performance against this more clearly defined and rigorous objective should be independently reviewed three years after a revised Statement of Expectations is issued by the Minister or the amendments to the EFIC Act have been passed by Parliament, whichever occurs first. The review should consider whether the rationale for government intervention based on information failures remains valid. It should also determine whether the provision of financial services through EFIC has been effective, and if it is the most efficient way of addressing any failures in finance markets that are impeding otherwise commercially viable export transactions.

If the private sector increasingly recognises opportunities to service newly exporting SMEs and the demand for EFIC's services gradually declines over time, this should be considered a policy success. If on the other hand, EFIC struggles to develop a sustainable business, this would be evidence that either the market failures of concern are not extensive or they are not amenable to being addressed through the direct provision of financial services by EFIC. These matters would need to be considered in the independent review.

Table 2 Selected features of current and proposed arrangements

EFIC's activities on the commercial account

	Current arrangements	*Proposed arrangements*
Objective	Facilitate and encourage Australian export trade Operate in the market gap	Address potential information-related market failures affecting newly exporting small and medium-sized enterprises' (SME) access to export finance
Policy mechanism	Provision of export finance and insurance that is not always priced on a commercial basis	Demonstrating to the private sector that providing export finance to exporting SMEs can be commercially viable Transparent and limited provision of export finance to SMEs, reflecting expected full economic cost
Governance	Insufficient internal and independent oversight of compliance with mandate	Internal audit program and independent review of compliance with mandate Improved transparency through publication of corporate plan
	Reporting arrangements that are inadequate to assess EFIC's performance	Reporting against a performance management framework reflecting the clearly defined, rigorous objective. More frequent reporting to the Minister Independent review against the new limited mandate three years after revised Statement of Expectations or legislative amendments have passed
Scope and focus	Focus on large corporate clients, and resource-related projects in Australia	Focus on newly exporting SMEs A direction from the Minister to cease support for resource projects located in Australia, and related infrastructure, and suppliers to those projects
	Broad range of products overlapping with those offered by the private sector	Product range limited to guarantees and bonds, including the provision of bonds on behalf of exporters
	No limits on the number of facilities per client. Often repeat clients	Normally three facilities per client. Proposals beyond the three facility limit should either relate to an emerging export market, or require approval by the Board, be notified to the Minister and be included in EFIC's internal audit program and independent review
	Support can include provision of facilities for transactions indirectly related to Australian export trade	Transactions limited to those based on an export contract
	Relationships with financial institutions beyond demonstration role	Engagement with financial institutions based on demonstrating commercial viability through transparency in pricing, facing the expected full economic cost of provision
Operational outcomes	Low rate of return on equity	Return on equity appropriately benchmarked
	The price of some facilities is not sufficient to cover expected full economic costs	Pricing that reflects the expected full economic cost of provision, underpinned by compliance with competitive neutrality arrangements
	Strategic conduct by clients	Low incentive for strategic conduct by clients due to appropriate pricing, transparency and increased disclosure requirements
	Misallocation of resources that impose an efficiency cost on the Australian economy	Private sector provision of export finance to newly exporting SMEs achieved through a demonstration effect

Findings and recommendations

Provision of financial products

FINDING 3.1

Most products offered by EFIC are also offered by the private sector, although the price and other conditions of provision may differ.

FINDING 4.1

There can be sound commercial reasons why private sector providers do not offer some products or are unwilling to provide them to some exporters or buyers. Such cases are not market failures.

Rationale for government intervention

FINDING 5.1

The following arguments are not sound policy rationales for government involvement in export finance and insurance through EFIC:

- *EFIC can assume more risk than the private sector is willing to accept because it is government owned.*
- *EFIC is necessary to address cross-border regulatory problems faced by exporters.*
- *EFIC can be used to address problems arising from insufficient competition in Australian financial markets.*
- *EFIC can address imbalances in the supply of, and demand for, capital.*

FINDING 5.2

The decline in the provision of trade finance during the global financial crisis was primarily due to lower levels of international trade and resulting lower demand for trade finance products. As such, government policy aimed at ameliorating the decline in international trade through the provision of export finance and insurance through EFIC would not have been successful.

RECOMMENDATION 5.1

The Minister should amend the Statement of Expectations to require EFIC to define a small and medium-sized enterprise as an entity, including any related entities, with fewer than 100 full-time equivalent employees or annual turnover of less than $50 million.

FINDING 5.3

The only potential rationale for government involvement in export finance and insurance through EFIC relates to information problems affecting access to export finance and insurance by newly exporting small and medium-sized enterprises. The possible sources of those problems are:

- *inadequate information about the credit history and standing of the exporter, which could result in private sector providers employing rigid generalised rules and not forming an assessment on the merits of the transaction*
- *inadequate information about the risk associated with some emerging markets, which could result in private sector providers refusing to provide services for transactions in those markets*
- *temporarily missing markets due to severe disruption in the importing country.*

Pricing of EFIC's products

FINDING 6.1

EFIC does not pay income tax, is not required to earn a particular rate of return on equity and the Export Finance and Insurance Corporation Act 1991 provides for its liabilities to be explicitly guaranteed by the Commonwealth. This lowers its borrowing costs relative to private sector providers, giving it a commercial advantage that may discourage market entry by potential competitors.

RECOMMENDATION 6.1

The Minister should amend the Statement of Expectations to require EFIC to commission an independent review of the process it follows to allocate an EFIC risk score (ERS) to a facility. This review should include a comparison of the ERS of each facility at signing and at maturity to examine any changes over time. Evaluating the forecasting accuracy of expected losses compared to actual losses will help ensure that EFIC prices risk appropriately. EFIC should report the results of this review to the Minister.

FINDING 6.2

Not all of EFIC's facilities are priced to earn a commercial rate of return on equity and hence, do not cover their expected full costs, including the opportunity cost of capital. These facilities are effectively being subsidised by taxpayers. The beneficiaries of these subsidies likely extend beyond EFIC's clients and may include private sector providers, other export credit agencies and the buyer of the exports.

RECOMMENDATION 6.2

The Australian Government should amend the Export Finance and Insurance Corporation Act 1991 (EFIC Act) to ensure EFIC's activity on the commercial account complies with competitive neutrality arrangements. This will require EFIC to pay a tax-equivalent charge and a debt neutrality fee.

The Minister should amend the Statement of Expectations to:

- ***require the pricing of EFIC's commercial account facilities to reflect the expected full economic cost of provision, including the opportunity cost of capital, taxes paid by private sector participants and the benefit that EFIC obtains from the government guarantee***
- ***set an appropriately benchmarked rate of return on equity following consultation with the Treasurer and the Minister for Finance***
- ***require EFIC to identify in its annual report and corporate plan that part of its revenue that relates to not having to pay a tax-equivalent charge and debt neutrality fee, until the EFIC Act is amended to apply competitive neutrality arrangements.***

Filling the 'market gap': not a role for government

FINDING 7.1

The concept of the market gap can cover circumstances where there is no market failure that would warrant government intervention through EFIC. EFIC has provided assistance on the basis of the market gap in circumstances that are not a result of market failure including:

- *a reluctance by firms to dilute the equity of existing shareholders by taking on additional equity partners as a firm expands*
- *firms exhausting other forms of debt or equity finance*
- *meeting the credit preferences of the firm's owners*

- *participants making EFIC's involvement a precondition of the transaction or project proceeding*
- *reluctance by an exporter or buyer to incur the transaction costs of finding more supportive bankers*
- *firms reaching the prudentially determined credit limits of their banks*
- *private sector providers declining to supply services because of recent financial distress of the client*
- *timeframes determined by approval processes, including government approval processes, not being met without EFIC's assistance*
- *private sector providers seeking to make a transaction or project more attractive through EFIC's participation.*

RECOMMENDATION 7.1

The Minister should remove the 'market gap' mandate from the Statement of Expectations as it lacks rigour and does not ensure that EFIC's activities generate a net benefit to the economy.

FINDING 7.2

There is no convincing evidence that there are problems relating to the provision of capital to large Australian resource-related projects, or the suppliers to these projects, which require intervention by the Australian Government through EFIC.

FINDING 7.3

Where EFIC's activities are not addressing a market failure, EFIC will be distorting the allocation of resources within the economy. These distortions include potential crowding out of other sources of finance, other projects, or competitors of EFIC's clients.

At present, EFIC's relatively small size limits the economy-wide consequences of this. However, some facilities are of sufficient magnitude to pose non-trivial financial risks to the Commonwealth.

EFIC and private sector providers

FINDING 7.4

Some financial market participants have a partnership relationship with EFIC, being able to benefit directly from EFIC's involvement in facilities, through both risk transfer and higher returns.

Risk management

FINDING 8.1

EFIC's internal auditors observed that EFIC has had high exposure to certain industries, including ship building and operation, and to a few countries.

The Commission considers that some aspects of EFIC's credit risk management have not always been sufficiently robust.

RECOMMENDATION 8.1

EFIC should revise its risk management policies to include a limit on exposures to particular industries.

FINDING 8.2

EFIC's capital adequacy ratio at 30 June 2011 was well above the minimum level specified by Australian Prudential Regulation Authority guidelines and EFIC's internal benchmarks. The extra capital held by EFIC has an opportunity cost that is borne by the taxpayer.

Financial and operational performance

FINDING 8.3

A large proportion of EFIC's income is earned through its treasury operations, with EFIC's origination business accounting for less than half of its income in each of the past five years.

RECOMMENDATION 8.2

The Treasury and the Department of Finance and Deregulation should regularly review the need for, and the scope of, EFIC's treasury function to ensure that the size of treasury operations is commensurate with the size and product offering of the origination business it supports.

The first review of this type should include an assessment of EFIC's capital requirements and dividend policy, and be completed by June 2013.

RECOMMENDATION 8.3

The Export Finance and Insurance Corporation Act 1991 should be amended to allow the Minister to direct the Board of EFIC to return capital to the Australian Government when the Minister determines that EFIC has surplus capital, after seeking the views of the Treasurer and the Minister for Finance.

FINDING 8.4

The Australian Government has not received an adequate return for the risk it has incurred from EFIC's operations. This may reflect a number of factors, including that some facilities are not priced to reflect their expected full economic cost (given the risk incurred), a high level of retained capital, and possibly high operating expenses.

Enhancing the transparency of EFIC's operations

RECOMMENDATION 9.1

Consistent with the findings of the Uhrig Review, the Australian Government should amend the Export Finance and Insurance Corporation Act 1991 to exclude Australian Public Service personnel from the EFIC Board. Where the EFIC Board considers departmental advice beneficial, officials from the Department of Foreign Affairs and Trade should be invited to present to board meetings for the relevant agenda items and to answer questions relating to those items.

FINDING 9.1

The Commission is not satisfied that the EFIC Board is provided with sufficient information in board papers to evaluate whether facilities submitted for approval on the commercial account are meeting the requirements set out in the Minister's Statement of Expectations with regard to pricing, or to determine that EFIC is not competing with the private sector.

EFIC's compliance with the operational restrictions in the Minister's Statement of Expectations and Part 4 of the Export Finance and Insurance Corporation Act 1991 has not had sufficient focus in independent reviews or EFIC's internal audit program over the past five years.

RECOMMENDATION 9.2

The Minister should amend the Statement of Expectations to require EFIC to include in its regular internal audit program an assessment of its compliance with the operational restrictions, as set out in the Statement of Expectations, any relevant directions from the Minister, and Part 4 of the Export Finance and Insurance Corporation Act 1991. Board papers should be sufficiently robust to ensure that they can be used in EFIC's internal audit program to confirm that EFIC is complying with its mandate.

FINDING 9.2

There is insufficient clarity in the information provided by EFIC to the Australian Government and the public, and this impairs EFIC's accountability.

RECOMMENDATION 9.3

The Minister should table EFIC's corporate plan in Parliament and, in due course, the Export Finance and Insurance Corporation Act 1991 should be amended to require this.

EFIC should provide quarterly progress reports to the Minister against its corporate plan, including information about facilities on the commercial account executed during that quarter.

RECOMMENDATION 9.4

The Minister should amend the Statement of Expectations to require the EFIC Board to establish a performance management framework, based on a more clearly defined and rigorous objective under the Export Finance and Insurance Corporation Act 1991, directed at market failures affecting small and medium-sized enterprises. The framework should be developed in consultation with other Australian Government agencies, and use relevant performance benchmarks and indicators for EFIC's business units, including treasury operations.

EFIC should report its performance against this framework in its annual report and corporate plan.

National interest account

RECOMMENDATION 9.5

Proposed facilities with national interest objectives should only be considered in the context of the national interest account.

The Australian Government's assessment of national interest account facilities should include analysis of whether the proposal is the most cost-effective way of achieving intended outcomes.

The Australian Government should clearly and publicly articulate the justification for a national interest account facility after it has been approved by the Minister.

Information on the performance of national interest account facilities should be collated and publicly reported by the Australian Government.

Environmental and social responsibility

FINDING 9.3

Increased public disclosure of information relevant to environmental and social impact assessments, including contractual terms to manage and mitigate risk, would enhance the transparency of EFIC's operations to the public and to the Australian Government.

RECOMMENDATION 9.6

The Minister should amend the Statement of Expectations to require EFIC to publicly disclose its prospective involvement in any facility with potentially significant environmental or social impacts. This includes all category A projects, and 'non-projects' and bonds where it has been determined that there is potential for significant environmental and social impacts.

Information relating to the environmental and social classification of projects and the reasons for their approval should be predictable and disclosed in the annual report and on EFIC's website. This information should include assessment benchmarking and processes, conditions of approval and consequences for non-compliance. Information that is relevant to EFIC's assessment of environmental and social impacts should be made public.

EFIC should make public its involvement in supporting projects that are subject to environmental assessment in Australia.

RECOMMENDATION 9.7

The Minister, by way of a direction under the Export Finance and Insurance Corporation Act 1991, should articulate which international obligations, including human rights obligations, EFIC is required to comply with.

EFIC's compliance with those obligations should be included in its internal audit program with outcomes publicly reported, including in EFIC's annual report.

RECOMMENDATION 9.8

The Australian Government should remove EFIC's special exemption in relation to matters done under Parts 4 and 5 of the Export Finance and Insurance Corporation Act 1991 from the Freedom of Information Act 1982 (while retaining protection for Cabinet and commercial-in-confidence material).

Limiting the scope of EFIC's activities

RECOMMENDATION 10.1

As soon as possible, the Minister should direct EFIC to cease providing financial services for transactions that are not based on an export contract as defined in section 3 of the Export Finance and Insurance Corporation Act 1991 (EFIC Act). This includes resource projects located in Australia, and related infrastructure, and suppliers of goods and services to those projects.

The Australian Government should not broaden the eligibility criteria under Part 4 of the EFIC Act. Specifically, the EFIC Act should not be amended to allow EFIC to enter into loans for the export of non-capital goods.

EFIC's future role

RECOMMENDATION 10.2

Until it is next reviewed by an independent body, EFIC's role on the commercial account should be limited to demonstrating to the private sector that providing export finance to newly exporting small and medium-sized enterprises (SMEs) can be commercially viable. This demonstration role should be articulated in the Minister's Statement of Expectations.

EFIC should demonstrate that the provision of financial services to newly exporting SMEs can be done on the same basis as the private sector — with price covering the expected full economic cost of provision.

RECOMMENDATION 10.3

In respect of the commercial account, the Australian Government should make amendments to the Export Finance and Insurance Corporation Act 1991 (EFIC Act) to:

- ***reorient EFIC's objective to addressing information-related market failures in financial markets affecting newly exporting small and medium-sized enterprises (SMEs) seeking access to export finance***
- ***specify that EFIC is to demonstrate to the private sector that providing export finance to newly exporting SMEs can be commercially viable***
- ***clarify that assistance is only to be provided in respect of export contracts as currently defined in the EFIC Act***
- ***remove references to EFIC providing support to persons indirectly involved in Australian export trade***
- ***limit the financial products offered by EFIC to guarantees and bonds falling within the definition of 'guarantee' under section 3 of the EFIC Act***
- ***allow for the product range to include the provision of reinsurance cover for sovereign and country risk insurance provided by the private sector in times of disruption in particular markets, subject to ministerial direction.***

RECOMMENDATION 10.4

A limit of three facilities per client should normally apply to EFIC's future operations on the commercial account. Proposals to exceed this limit should be subject to at least one of the two conditions below:

- ***the export transaction is in an emerging export market or***
- ***the facility has been explicitly approved by the EFIC Board (and not by a delegate), is notified to the Minister and is included in EFIC's internal audit program and independent review of EFIC's operations.***

The limit of three facilities should not apply to political risk reinsurance facilities provided pursuant to the direction by the Minister.

RECOMMENDATION 10.5

EFIC should publish information on the facilities it approves on the commercial account within a month of execution, including the name of the firm, price and other terms of provision.

Implementation and review

RECOMMENDATION 10.6

Where possible, the Minister should give effect to the proposed changes to EFIC's operations through a ministerial direction or a revised Statement of Expectations, until such time as the Export Finance and Insurance Corporation Act 1991 can be amended.

RECOMMENDATION 10.7

EFIC's performance against the more clearly defined and rigorous objective should be independently reviewed three years after a revised Statement of Expectations is issued by the Minister or the amendments to the Export Finance and Insurance Corporation Act 1991 have been passed by Parliament, whichever occurs first.

This independent review should consider whether the rationale for government intervention remains valid, and whether the provision of financial services through EFIC is the most effective and efficient way of addressing any failures in financial markets that are impeding otherwise commercially viable export transactions. This review should also include examination of alternative arrangements for post-approval administration of the national interest account.

1 Introduction

The Australian Government has asked the Productivity Commission to inquire into Australia's arrangements for the provision of export credit through the Export Finance and Insurance Corporation (EFIC). The terms of reference for the inquiry require the Commission to consider, among other matters, the rationale for government provision of export finance and insurance products and the efficiency of providing these products through EFIC.

The current minister responsible for EFIC is the Australian Government Minister for Trade and Competitiveness. For the purposes of this report, 'the Minister' refers to the Australian Government Minister responsible for EFIC, unless otherwise specified.

1.1 Background to this inquiry

EFIC is Australia's export credit agency — the government provider of export credits, insurance, reinsurance and other financial services that support Australian exports and overseas investments. Although its activities can be traced back to the 1950s, EFIC was established in its current form in 1991 under the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act) as an independent statutory corporation wholly owned by the Commonwealth of Australia. As set out in the Minister's Statement of Expectations, EFIC is to operate a commercial account under a 'market gap' mandate — it is only to provide services to viable projects where the private sector is unwilling or unable to provide support.

EFIC also manages the national interest account (NIA) on behalf of the Australian Government. Each NIA transaction is approved by the Minister. National interest considerations may include the delivery of foreign aid or meeting foreign policy objectives, such as regional stability and growth.

EFIC has been subject to a number of government reviews since its inception (box 1.1). EFIC was last reviewed by the Department of Foreign Affairs and Trade in 2006. The review made a number of recommendations on EFIC's governance arrangements, including proposed amendments to the EFIC Act that are relevant to this inquiry.

Box 1.1 **Previous reviews of EFIC**

EFIC has been subject to a number of direct reviews within government since its inception.

- In 2000, an interdepartmental steering committee under the direction of the Minister conducted a review of Australian Government involvement in the provision of export credit and finance through EFIC. The review found that there was limited private sector support for medium-term export finance and political risk insurance, but expanding private sector provision of short-term export credit insurance. The review considered that EFIC's export finance business should remain with EFIC but identified options for reforming EFIC's short-term export credit insurance business, including phased privatisation. EFIC's short-term export credit insurance business was divested in 2003.
- In 2003, the Department of Foreign Affairs and Trade (DFAT) commissioned Ernst & Young to assess the appropriateness of EFIC withdrawing from the short-term export credit insurance market. EFIC and Gerling NCM formed an alliance to provide the opportunity to demonstrate Gerling NCM's capacity to meet exporters' needs for short-term insurance. The review assessed Gerling NCM's performance against certain divestment benchmarks. EFIC's short-term export credit insurance business was subsequently divested in 2003.
- DFAT reviewed EFIC in 2006 and found that:
  - the divestment of EFIC's short-term insurance business had been successful, with the market effectively served by the private sector since the divestment
  - the 'market gap' in which EFIC operates was shrinking due to greater private market capacity for export finance and insurance, but the review found no strong evidence that EFIC was consistently extending its support beyond the market gap or undercutting private providers on price
  - although private capacity had increased, long-term insurance markets, particularly political risk insurance, remained the domain of export credit agencies
  - there was no evidence that EFIC's abolition would result in the private market 'filling the gap', with the private sector 'simply unwilling' to cover some risks and tenors
  - small and medium-sized enterprises (SMEs) were not well served by the private market, which has reservations about the durability and profitability of many SMEs. This is particularly the case with SMEs that are new or irregular exporters.

(Continued next page)

Box 1.1 (continued)

- the responsibilities of management and the Board of EFIC to operate in the market gap should be set out in the Minister's Statement of Expectations (SoE). The SoE should include a statement of principle that EFIC's pricing is not to undercut the pricing of the private sector when private support is present, and not to undercut pricing for comparable risks when private support is absent and, where appropriate, that EFIC charge a premium for the additional risk or quality of service it is providing.

Broader government reviews also have implications for EFIC.

- The 2003 Uhrig Review of the corporate governance of statutory authorities and office holders found that statutory authorities whose major activities are commercial in nature will generally be better suited to operate under a board. To be effective, such a board would need to have powers similar to those of the board of a publicly listed corporation, including the power to appoint and remove the Managing Director. The Uhrig Review considered that boards should be subject to annual assessments to ensure government gets the best performance from the board.
- The 2008 Mortimer Review of Australia's export policies and programs found that:
  - A common problem among new exporters was a lack of understanding about financial products available and where to obtain finance.
  - There was scope for increased cooperation between Austrade and EFIC to raise awareness of EFIC's products.
  - The Australian Government should enact a limited expansion of EFIC's powers to enable it to assist Australian companies seeking to invest offshore, where these companies are small and new to offshore investment and where the private sector is unwilling to provide support.
  - It would be desirable to have a common framework for the design and monitoring of financial assistance programs for exporters, and the Government should commit to regular assessment of such programs.
  - Any financial assistance that is not clearly directed at demonstrated market failures and does not result in additional exports should be abolished or phased out.

Sources: DFAT (2001; 2006; pers. comm., 8 May 2012); Mortimer (2008); Uhrig (2003).

Over the past 25 years there has been substantial change in the Australian financial sector. Australian businesses now have access to extensive and sophisticated capital and insurance markets, both domestic and foreign, with financial intermediaries providing a range of services. The activities and international obligations of export credit agencies in Australia and internationally, as well as the trade financing role of multilateral development banks, have also undergone a considerable transformation since government export credit arrangements were established in Australia. Given this, it is appropriate that the government's role in the provision of export credits, and support for Australian exports and overseas investments through financial products and services more broadly, be extensively reviewed.

1.2 What has the Commission been asked to do?

The Commission has been asked to undertake a public inquiry into Australia's arrangements for the provision of export credit through EFIC. This includes:

- reviewing the rationale for government involvement in the provision of export finance and insurance, and assessing current arrangements against the requirements of the EFIC Act
- assessing EFIC's management of credit and funding risks
- reviewing EFIC's pricing and service arrangements and assessing their impact on incentives for Australian exporters to access private sector providers of export finance and insurance products
- reviewing EFIC's exemption from competitive neutrality policy
- assessing the interactions between EFIC and other government programs and considering alternatives that would achieve EFIC's objectives.

The Commission's approach

The Commission's approach to this inquiry takes into account the matters specified in the terms of reference and is ultimately directed by the general policy guidelines in the *Productivity Commission Act 1998* (Cwlth) (PC Act). Among other things, section 8 of the Commission's Act directs it to:

> (a) improve the overall economic performance of the economy through higher productivity in the public and private sectors in order to achieve higher living standards for all members of the Australian community
>
> (b) encourage the development and growth of Australian industries that are efficient in their use of resources, enterprising, innovative and internationally competitive.

In keeping with the PC Act, the Commission has taken an economy-wide perspective. This involves identifying if there is a market failure warranting intervention, the most appropriate form of intervention, and evaluating whether EFIC's activities and governance arrangements efficiently implement that intervention.

1.3 Conduct of the inquiry

The Commission has followed its usual transparent and public processes, with an overarching concern for the wellbeing of the Australian community as a whole.

The Commission:

- met informally with EFIC, banks, insurance companies, representatives of large and small businesses, the ACTU, and government officials (listed in appendix A)
- released an issues paper in October 2011 outlining a range of issues on which it was seeking comment and information from participants: 27 submissions were received
- released its draft report *Australia's Export Credit Arrangements* on 22 February 2012 and sought feedback on the proposals in that report. A further 89 submissions were received
- held public hearings in Perth, Canberra and Sydney (table 1.1). The Commission scheduled an additional hearing day in Sydney to allow for the public examination of EFIC's final submission.

Table 1.1 **Schedule of public hearings**

Location	*Date*
Perth	Friday, 23 March 2012
Sydney	Monday, 26 March 2012
Canberra	Tuesday, 27 March 2012
Sydney	Wednesday, 4 April 2012

The Commission has given consideration to all submissions received during this inquiry. Feedback on the draft report, including material provided by EFIC, was drawn on in finalising this report with some findings and recommendations amended accordingly.

The Commission has undertaken economic analysis consistent with its terms of reference, basing its findings and recommendations on the evidence available. This economic analysis does not constitute a performance or compliance audit of EFIC's financial and legal affairs.

The Commission expresses its gratitude to all those who assisted with this inquiry process.

2 Export Finance and Insurance Corporation

Key points

- Many countries make use of officially backed export credit agencies (ECAs) to facilitate the provision of finance and insurance services to promote exports. ECAs can offer a range of financial services including: credit to exporters or their foreign buyers, guarantees, bonds, and credit and political risk insurance.
- The Export Finance and Insurance Corporation (EFIC) has been established to facilitate and encourage Australian export trade through the provision of financial services. It provides these services on a commercial account (CA) and manages the national interest account (NIA) on behalf of the Australian Government.
- The Minister can approve, or direct, transactions on the NIA that are in the national interest. EFIC is reimbursed for any losses on the NIA, remits any profits to the Australian Government and receives a fee for its administration.
- EFIC is to operate the CA on commercial terms and generate revenue to fund its operation through fees and premiums for its services. Under the EFIC Act the Australian Government guarantees payments to all EFIC's creditors.
- EFIC maintains a treasury operation that it uses to facilitate borrowing on domestic and international capital markets to fund its origination activities, to structure Australian dollar and foreign currency cash flows arising from transactions and to manage EFIC's investment portfolio of capital and reserves.
- EFIC is exempt from the Australian Government's competitive neutrality arrangements. This means EFIC is not subject to requirements to earn a particular rate of return, does not pay income tax and a number of other taxes, and does not pay a debt neutrality charge to offset the competitive advantages provided by its explicit government guarantee. This places EFIC at a considerable advantage to private providers.
- At present EFIC is generally focused on large firms and often repeat customers. Virtually all Australia's export trade, by both volume and value, takes place without EFIC's assistance. In 2009-10 EFIC provided 54 facilities to 41 clients on the commercial account. In the same financial year there were about 45 000 goods and services exporting businesses in Australia.
- In addition to EFIC's services, the Australian, state and territory governments provide a range of financial and advisory products and services that assist exporters. The Commission estimates that the gross value of budgetary assistance to exporters provided by the Australian Government was $522 million in 2010-11. This does not include general support programs that are available to exporters, or assistance provided by state and territory governments.

2.1 The role of international trade in the economy

International trade increases aggregate welfare by allowing specialisation along the lines of comparative advantage, thereby redirecting resources to their highest valued uses, and expanding the consumption choices available to consumers and producers in trading nations. International trade can also generate gains in productivity and allow benefits from economies of scale. Competing in international markets may also confer dynamic (long-run) benefits that arise from the development or transfer of more efficient management skills and technologies, and the training of higher-quality labour.

In 2010-11, Australia imported goods and services to the value of $277 billion and exported goods and services to the value of $297 billion, or about 20 per cent of GDP (ABS 2011a). This inquiry will focus on Australia's export market (box 2.1) but imports, as well as exports, raise the productivity and wellbeing of a nation's citizens.

Box 2.1 **The characteristics of Australia's export market**

In 2009-10 there were about 45 000 goods and services exporting businesses in Australia. Goods accounted for 79 per cent of the value of exports. The mining industry was the main goods exporting industry, accounting for 48 per cent of the total value of goods exported, despite being only 1.3 per cent of exporters. The travel services industry was the main services exporting industry, accounting for 63 per cent of the total value of services exports.

Based on ABS definitions of business size (box 2.4), in 2009-10 there were 4274 large businesses exporting goods. These businesses represented only 10 per cent of all businesses exporting goods but accounted for more than 90 per cent of the total value of all goods exports. In contrast, medium-sized businesses represented 49 per cent of all goods exporters by number, but accounted for only 6 per cent of the total value of goods exports. Small businesses made up 41 per cent of all goods exporters and contributed less than 1 per cent of the total value of goods exports.

In 2010, Australia's main export markets were: China, with 23 per cent of the total value of exports; Japan (16 per cent); the Republic of Korea (8 per cent); India (7 per cent); and the United States (5 per cent).

Sources: ABS (2011c); DFAT (2011b).

A well-developed finance sector facilitates trade. Financial markets enable trade by providing credit that allows trading partners to bridge the time between an export order and payment for goods and services produced. Financial markets also facilitate debt and equity investment in domestic infrastructure that supports export industries. Furthermore, financial institutions allow and secure money flows across borders, provide information about foreign countries and their 'riskiness', and insure against trade-related risks (Grath 2008).

Trade finance and the role of export credit agencies

Many governments provide trade finance and insurance through export credit agencies (ECAs) as a means of increasing exports, as they see increased exports as a way of raising national income. An increase in the volume of exports *may* increase national income but that is not always the case. For example, in order to sell more exports, prices may need to fall, offsetting any increase in export volumes.

In economies that are close to or at full employment, efforts to increase exports will come at the expense of other sectors as labour and other resources are drawn from other parts of the economy. It is not necessarily the case that income and employment will rise.

In other cases, policies that support exports may enhance the competitiveness of foreign companies that directly compete with Australian exporters. For example, support may be given to Australian exporters that produce goods or services used in overseas mining projects that compete in international markets with output from Australian mines. Governments also use ECAs to achieve other objectives such as supporting industries considered important to national security or securing greater certainty over imported resources required for domestic industries.

Export credit can reduce the risk associated with an export transaction by giving a buyer time to distribute goods for resale before making payment to the exporter, or in the case of capital goods, time to generate revenue through use in production processes. The maturities of trade finance facilities are closely linked to the type of export (Wang et al. 2005). Generally, capital goods require longer term credit arrangements due to their high cost, while consumer goods are usually financed through short-term credit (Madura 2008). For this reason, ECA assistance is usually biased toward the finance of capital goods on the basis that they generally require large repayments and longer tenor[1] (Wang et al. 2005). The perceived need for ECAs to assist the financing of capital goods does not necessarily reflect any inefficiency in financial markets.

ECAs can be government departments, government corporations or private companies administering an account for or on behalf of government, separate from the commercial business of the institution. ECAs provide a range of products

1 The term of the facility.

including credit to exporters, guarantees, bonds, insurance against non-payment of obligations, and direct loans to exporters, financiers or overseas buyers. The operation of ECAs in other countries is discussed in more detail in appendix C.

Australia's ECA, the Export Finance and Insurance Corporation (EFIC) is a small ECA by global standards. While it is difficult to estimate the exact percentage of Australian exports assisted by EFIC, it is likely to be no more than a few per cent. Virtually all Australia's export trade, by both volume and value, takes place without EFIC's assistance.

2.2 Export Finance and Insurance Corporation

Australia has had an ECA since the establishment of EFIC's predecessor, the Export Payments Insurance Corporation (EPIC) in 1957. EPIC operated as an insurer of last resort for exporters and this role was significantly expanded with the establishment of EFIC in 1974. EFIC obtained additional powers to insure financiers of exporters, insure overseas investments, guarantee tenders and performance, and lend to purchasers of Australian capital goods.

In 1985, EFIC's powers were transferred to the Australian Trade Commission (Austrade) and it was re-established in 1991 as a statutory authority under the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act).

Functions

EFIC was established to facilitate and encourage Australian export trade through the provision of financial services and insurance products, and publish information relevant to Australian exporters. Its main functions under the EFIC Act are to:

- encourage and facilitate Australian export trade
- encourage banks and other financial institutions carrying on business in Australia to assist in financing export contracts
- manage the Australian Government's aid-supported loan program[2]
- provide information and advice regarding insurance and financial products available to support Australian exports (EFIC Act, s. 7).

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2 The government mixed credit program, the Development Import Finance Facility, was discontinued on 23 July 1996. However, EFIC is still required to manage a portfolio of outstanding loans.

EFIC undertakes these functions by providing export finance and insurance products for eligible transactions using two accounts — the commercial account (CA) and the national interest account (NIA).

Commercial account

EFIC is expected to conduct its origination business on a commercial basis obtaining a rate of return reflecting the risk undertaken (Emerson 2011). Risks underwritten on the CA are carried initially by EFIC and any losses are borne from EFIC's accumulated capital and reserves. As EFIC is explicitly backed by a government guarantee, the government would ultimately bear any losses over and above EFIC's resources (to date this has not occurred). The Minister cannot require EFIC to obtain ministerial approval for a particular transaction, or direct EFIC to enter into a particular transaction, on the CA. However, the Minister may direct EFIC more generally as to how it performs its functions or the exercise of its powers under s. 9 of the EFIC Act.

National interest account

The Minister can approve, or direct, transactions on the NIA that are in the national interest although, by convention, Cabinet approval is sought. EFIC is able to refer transactions to the NIA for approval by the Minister. According to EFIC, referred NIA transactions tend to involve financial commitments too large for EFIC's balance sheet, or 'a risk — commercial or political — too great for EFIC to consider at any level on its Commercial Account' (EFIC, sub. DR90, p. 17).

EFIC manages the NIA facilities after approval by the Minister through a service level agreement with the Department of Foreign Affairs and Trade. EFIC is reimbursed for any losses on the NIA, remits any profits to the Australian Government and receives a fee for its administration. Any budgetary appropriation from the Consolidated Revenue Fund to EFIC that relates to the NIA is through the Department of Foreign Affairs and Trade and is scrutinised by the Australian Parliament (EFIC, sub. 18; DFAT, pers. comm., 11 May 2012).

Governance

EFIC's governance framework consists of the legislative and administrative controls through which external stakeholders, such as the Minister, exercise control over EFIC, and the internal corporate governance as overseen by EFIC's Board. EFIC's external governance framework is largely determined by the EFIC Act and the *Commonwealth Authorities and Companies Act 1997* (Cwlth) (CAC Act). EFIC's governance arrangements are discussed further in chapter 9.

The CAC Act sets out requirements in relation to aspects of EFIC's corporate governance, financial management and reporting. As a CAC authority, EFIC is required to notify the Minister of certain significant events such as the acquisition or disposal of interests in companies or other ventures. The EFIC Board must also keep the Minister informed about EFIC's operations and provide any information required by the Minister or the Minister for Finance. The CAC Act also gives the Minister and the Minister for Finance broad powers to require EFIC to provide information about its activities (DOFA 2005).

The Export Finance and Insurance Corporation Act 1991

EFIC is a statutory corporation under the EFIC Act and is part of the Australian Government's Foreign Affairs and Trade portfolio — with the Minister for Trade and Competitiveness having responsibility for EFIC. Under the Act, the Minister:

- may give written directions to EFIC in respect of the performance of its functions or the exercise of its powers if satisfied that it is in the public interest that directions be given (EFIC Act, s. 9). Current ministerial directions include transactions related to uranium, Iran, Zimbabwe and to the Democratic People's Republic of Korea (Emerson 2011)
- must appoint board members[3] to their statutory positions (EFIC Act, s. 34). The Minister can also terminate appointments under certain circumstances (EFIC Act, s. 43)
- either approves the recommendation from the Board on the payment of a dividend to the Australian Government or directs the payment of a different specified dividend by written notice to EFIC (EFIC Act, s. 55).

The EFIC Act requires that members of EFIC's Board and its employees keep client information confidential. EFIC has partial exemption from the *Freedom of Information Act 1982* (Cwlth). EFIC must report annually to Parliament. EFIC's

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3 The EFIC Board consists of the Chairperson and Deputy Chairperson; Managing Director; the government member; and as many other members, not fewer than two or more than five, as the Minister determines in writing to be appropriate. An appointed member, other than the government member, must be appointed for a term of three years. They are eligible for reappointment but must not hold office as a member of the Board for a total of more than two terms; or if the member has been appointed at any time as the Chairperson, three terms (EFIC Act, s. 35).

annual reporting requirements are set out in the EFIC Act and the CAC Act (box 2.2).

Box 2.2 **EFIC's formal reporting arrangements**

Australian Parliament and the Minister responsible for EFIC

- *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act) — reporting obligations including determinations regarding callable capital, recommendations on payment of dividends, determinations regarding insufficient capital and reserves to meet liabilities.
- *Commonwealth Authorities and Companies Act 1997* (Cwlth) (CAC Act) — reporting obligations including significant events, EFIC operations, budgetary estimates, and interim reports.
- Annual report tabled in Parliament by the Minister.
- EFIC is required to adhere to Parliamentary processes including Senate Estimates and Budget reporting requirements.
- EFIC's Statement of Intent in response to the Minister's Statement of Expectations (publicly available).
- A corporate plan that must meet the requirements of Part 7 of the EFIC Act. The corporate plan is not publicly available.
- EFIC is expected to respond in a timely manner to any request for assistance in formulating policy from the Minister, or the Department of Foreign Affairs and Trade (DFAT).
- Inform the Minister and DFAT of any approaches to restructure or relieve outstanding Development Import Finance Facility loans.

Department of Foreign Affairs and Trade

- The Secretary of DFAT (or their alternate) is the Government's representative on the EFIC Board.
- A service level agreement sets out reporting responsibilities for the management and administration of the national interest account (NIA).
- EFIC is expected to provide DFAT with full information on NIA transactions and NIA management.
- EFIC is to provide DFAT and any other relevant agencies with any non-legally privileged information they request to support them in preparing advice on policy related aspects of export credits and EFIC's operations.

Gazettal notice

- For NIA transactions, EFIC must publish a notice of details of a transaction entered into: the nature and extent of the insurance, indemnity or guarantee, or in the case of a loan, the amount provided and the extent of Australian Government liability.

(Continued next page)

Box 2.2 (continued)

Reports on EFIC's treasury operations

- Quarterly report on treasury counterparty exposure to both DFAT and the Department of Finance and Deregulation indicating EFIC's compliance with the investment constraints of the CAC Act.

Audit

- External audit of EFIC's accounts in accordance with the CAC Act through the Australian National Audit Office (ANAO), currently contracted to Ernst & Young.
- Other ANAO audits that may cover EFIC.
- Internal audit function, currently contracted to Deloitte.

Other

- Freedom of Information compliance (noting EFIC's partial exemption).
- Compliance reporting to the Australian Transactions Reports and Analysis Centre.
- Australian Government fraud control guidelines, copyright, and procurement plans.

Sources: CAC Act; EFIC Act; EFIC (sub. 18); Emerson (2011).

Eligibility criteria for provision of export finance and insurance

Beneficiaries of EFIC's services include Australian exporters, their buyers and financial intermediaries, subject to satisfying eligibility criteria specified in the EFIC Act (table 2.1). EFIC is able to provide financial services to firms located in Australia which contribute to the production of exports but do not themselves export. This has enabled EFIC to provide facilities to suppliers to resource-related projects located in Australia.

Under Section 3 of the EFIC Act, transactions must meet one of four criteria to be eligible for EFIC's services:

- *eligible export transaction*: a transaction relating to the export of capital goods manufactured wholly or substantially in Australia to be exported from Australia (including associated services), or the rendering of services for a person carrying on business in a foreign country
- *export contract*: a contract or agreement for the export of goods produced in Australia, whether in whole or in part, or for the rendering of a service to a person outside Australia
- *carrying on Australian export trade*: includes any transaction (including the rendering of a service) involving a benefit flowing directly or indirectly from overseas to a person carrying on business or other activities in Australia

- *overseas investment transaction*: a transaction involving either:
  - an acquisition of an interest in a foreign corporation proposing to carry on business in a foreign country
  - a right to share in the income or assets of a company carrying on business in a foreign country
  - lending or guaranteeing repayment of money in connection with a business in a foreign country
  - the transfer of money or other equipment in connection with a business in a foreign country (including a related business).

Table 2.1 **Eligibility criteria and how they are interpreted**

Section	*Financial product*	*Terminology used in the EFIC Act*	*What this means*
14	Export payments insurance	Carrying on Australian export trade	Transactions connected to a benefit flowing from overseas to a person carrying on business in Australia, including projects located in Australia, and associated supply chains.
16	Guarantees for loans to Australian suppliers	Carrying on Australian export trade	As above.
17	Guarantees for loans to overseas buyers	Export contract	Transactions involving the export of goods manufactured wholly or in part in Australia, or services rendered to a person outside Australia.
18	Guarantees to co-lenders	Eligible export transaction	Transactions involving the sale, production, supply, installation, operation, maintenance and repair of exported *capital* goods produced wholly or substantially in Australia, or services rendered to a person outside Australia.
23	Loans	Eligible export transaction	As above. Loans can be given to those who are not a party to the transaction.
19	Tender guarantees and performance guarantees	Export contract and eligible export transaction	Transactions involving the export of goods manufactured wholly or in part in Australia, or services rendered to a person outside Australia.
22	Insurance of overseas investment transactions	Overseas investment transaction	Transactions involving the acquisition of interest in a foreign business or of a right to share its income and assets; provision of loans or guarantees to foreign business; transferring of money or equipment to a foreign business.

Source: EFIC Act.

The EFIC Act is not the only determinant of whether EFIC can offer access to its products:

> The conditions of access to EFIC's products are governed by the EFIC Act, OECD Arrangement [on Officially Supported Export Credits] and EFIC's own management policies, such as Australian content requirements, and its Policy and Procedure on Environmental and Social Review of transactions. (sub. 18, appendix A, p. 34)

As noted by EFIC, the eligibility criteria for some products under the EFIC Act are broader than for others:

> Section 16 of the EFIC Act uses 'Australian export trade' as its criterion, which is a benefits-based test (see the definition of 'Australian export trade' in section 3(5)). Consequently, 'Australian export trade' is a broader eligibility criterion than the 'eligible export transaction' test. Section 18 on the other hand uses the term 'export contract' as its criterion which is defined in section 3(1) to cover goods generally, provided they are produced or manufactured wholly or in part in Australia. This is also a broader eligibility criterion than the 'eligible export transaction' test. (sub. 18, appendix A, pp. 33–34)

EFIC previously advised the Commission that 'the inconsistent product criteria can result in some products being less accessible than others' (sub. 18, appendix A, p. 33) and further stated that:

> The prescriptive drafting of Part 4 [of the EFIC Act] can limit EFIC's ability to both (i) provide assistance where a business or transaction deserving of EFIC's support does not meet the specific product requirements and (ii) develop innovative products and forms of assistance. (sub. 18, appendix A, p. 34)

However, the EFIC Act's eligibility criteria are very broad, conceivably covering any transaction in the export supply chain. For example, EFIC recently provided a $5.1 million performance bond on behalf of Greyhound Australia for the transport of staff to a site in the Pilbara where a gas plant is being constructed (EFIC 2012f). EFIC has also claimed that there may be scope under s. 23 of the EFIC Act for it to provide direct finance to foreign-owned resources projects in Australia, such as the Ichthys LNG project in northern Australia (trans., p. 295).

Ministerial Statement of Expectations

The Minister communicates his or her expectations of the EFIC Board through the publicly released Statement of Expectations (SoE) which, among other things, reiterates the requirement for EFIC to comply with General Policy Orders as set out in the CAC Act and with the requirements of the EFIC Act. A key requirement of the current SoE is that EFIC is not to compete directly with commercial providers — the basis for EFIC's 'market gap' mandate — and the rationale for EFIC's exemption from competitive neutrality arrangements.

The need for EFIC to fill a gap in the market was stated in the second reading speech when the EFIC Act was debated in Parliament. The market gap has been formally defined in the SoE as:

> … circumstances where the credit and insurance sectors are not able or are unwilling to provide credit and insurance services to financially viable Australian export transactions or overseas projects. (Emerson 2011, p. 1)

Statement of Intent

The EFIC Board is required to respond to the SoE through a publicly released Statement of Intent that confirms EFIC's intention to meet the Minister's expectations (EFIC 2011a). Through the Statement of Intent, EFIC has acknowledged the Minister's requirement for EFIC to not compete directly with private sector providers of trade finance and insurance and charge prices that reflect the risk undertaken:

> ... EFIC is to perform the functions specified in the EFIC Act only in circumstances where the credit and insurance sectors are not able or are unwilling to provide credit and insurance services to financially viable Australian export transactions or overseas projects. … EFIC pricing will not undercut the private sector and will reflect the risk undertaken ... (Mohl 2011, p. 1)

Corporate plan

The EFIC Board is also required to prepare a corporate plan (EFIC Act, s. 48). The plan is not publicly released. The EFIC Act states the plan must include information on EFIC's financial targets and strategies, with the Board having regard for:

- the need for EFIC to generate reserves sufficient to support expansion of its operations
- the adequacy of EFIC's capital
- any direction by the Minister for the payment of a dividend by EFIC for the financial year to which the target relates (EFIC Act, s. 49).

International obligations

The Minister requires EFIC to have regard to international agreements and commitments that Australia is a party to including the Australian Government's World Trade Organisation (WTO) commitments (such as the WTO Agreement on Subsidies and Countervailing Measures). Agreements identified by the Minister in the SoE include the United Nations Convention against Corruption, the OECD

Common Approaches on Environment and Officially Supported Export Credits and the Equator Principles (Emerson 2011).

In addition to those agreements identified by the Minister in the SoE, EFIC states that it respects a number of other international agreements including the OECD Arrangement on Officially Supported Export Credits; the OECD Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Export Credits to Low Income Countries; OECD Guidelines for Multinational Enterprises; and the Berne Union Guiding Principles (box 2.3). EFIC also states that:

> EFIC, as a member of the Export Credits Group (ECG) of the Organisation for Economic Co-operation and Development (OECD), complies with the OECD Council Recommendation on Bribery and Officially Supported Export Credits. The Recommendation outlines measures to be undertaken by ECG members to deter and combat bribery in connection with officially supported export credits. (EFIC ndb)

Box 2.3 **International agreements**

EFIC states that it 'respects the international agreements to which Australia is a party that relate to its business' (EFIC 2011a, p. 46). These agreements include:

The Equator Principles

A set of voluntary standards for determining, assessing and managing social and environmental risk in project financing. The principles apply to new project financing with total project capital costs of US$10 million or more.

OECD Common Approaches on Environment and Officially Supported Export Credits

A non-binding recommendation that intends to promote good environmental practice. The recommendation applies to projects financed with officially supported export credits with a repayment term of at least two years. EFIC states that its compliance with the OECD Common Approaches is monitored by peer review from other export credit agencies (ECAs), as well as semi-annual reporting to the OECD.

OECD Arrangement on Officially Supported Export Credits

A non-binding 'gentlemen's agreement' that sets out the most generous export credit terms and conditions that may be offered by participants to the OECD Arrangement. EFIC states that as a result of the OECD Arrangement it can only provide support for up to 85 per cent (or 80 per cent for ships) of the eligible contract value of a transaction. The OECD rules for project finance in high income countries also require that the ECA supported component of any loan syndication is less than 50 per cent of the total syndication. Investment insurance, short-term working capital facilities and bonding facilities are not covered by the OECD Arrangement.

(Continued next page)

Box 2.3 (continued)

OECD Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Official Export Credits to Low Income Countries

This agreement seeks to ensure that the provision of official export credits to public, or publicly guaranteed, buyers in low income countries reflects sustainable lending practices by supporting the buyer country's economic and social progress without endangering its financial future and long-term development prospects.

OECD Recommendation on Bribery and Officially Supported Export Credits

Provides a number of guidelines to deter and combat bribery in officially supported export transactions, including that ECAs inform exporters requesting their support about the legal consequences of bribery in international business, and require exporters to declare that neither they, nor anyone acting on their behalf, have been engaged or will engage in bribery for the supported transaction.

OECD Guidelines for Multinational Enterprises

The OECD Guidelines provide voluntary principles and standards for business conduct in areas such as employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.

United Nations Convention against Corruption

The Convention against Corruption obliges state parties to implement a range of anti-corruption measures. It establishes mechanisms for the prevention and criminalisation of corruption, as well as for international cooperation and asset recovery. Australia meets its obligations under the Convention through a combination of Commonwealth legislation; the work of various Australian Government bodies; procedural safeguards; self-regulation; and cooperation with regional and international authorities.

World Trade Organisation Agreement on Subsidies and Countervailing Measures

Prohibits governments or their ECAs from providing guarantees or insurance to exporters at rates below that necessary to recover long-term operating costs. The Agreement also prohibits the provision of finance at a rate less than the cost in international capital markets. A country can use the World Trade Organisation's dispute settlement procedure to seek the withdrawal of the subsidy or the removal of its adverse effects.

Berne Union Guiding Principles

The Berne Union is an international association for export credit and investment insurance. The Guiding Principles are a set of non-binding principles encouraging good governance among Berne Union members.

Sources: Attorney-General's Department (2011); EFIC (sub. 18; 2011a); Equator Principles Association (2006); OECD (2006a; 2007; 2008b; 2011a; 2011b).

It should be noted that these agreements contain numerous exemptions and concessions that limit their effectiveness. Moreover, with the exception of the WTO Agreement and the United Nations Convention against Corruption, these agreements are non-binding and lack rigorous enforcement mechanisms.

Corporate governance

EFIC's Board is responsible for EFIC's corporate governance — managing EFIC's affairs and overseeing its operations. EFIC states that it has a corporate governance framework consisting of: the Australian Stock Exchange's Corporate Governance Principles; a risk management framework (RMF); and a financial control framework (EFIC ndm).

The RMF describes the manner in which EFIC's risk appetite is established and controlled. EFIC's Board has ultimate responsibility for setting EFIC's risk appetite and tolerances, and EFIC's management is responsible for implementing Board-approved risk management strategies and policies. As part of the RMF, EFIC reports that it maintains a list of risks that it manages across its business, divided into the following categories:

- *strategic* — risk to revenues, earnings and product offerings as a result of ineffective corporate planning, specific government policy, trade policy or legislative implications, or poor decision-making or implementation of decisions
- *reputational* — risk of deterioration in the reputation of EFIC arising from adverse publicity
- *credit and country* — risk that a counterparty will default on obligations resulting in a financial loss
- *market* — risk of any fluctuation in the value of a portfolio resulting from adverse changes in market prices and market parameters including interest rates and exchange rates
- *operational and financial* — risk of loss resulting from inadequate or failed internal operational or financial processes and systems as well as the actions of people or from external events. EFIC has grouped operational risks into a number of sub-categories: general processes; external regulation; internal policies; domestic and international laws; and events (EFIC ndq).

EFIC states that its financial control framework contains various guidelines for the management of capital adequacy, large exposures and treasury operations (EFIC ndk).

EFIC's business operations

EFIC's origination business provides loans, guarantees and insurance products. The origination business is separated into a structured trade and project finance unit, responsible for supporting large corporate clients, and a small and medium-sized enterprises (SMEs) and mid-market unit to support SMEs (defined by EFIC as businesses with annual turnover of less than $150 million) (EFIC 2011a). EFIC's definition of SMEs differs from that used by other Australian Government agencies and Australian financial institutions (box 2.4).

Box 2.4 **Definition of small and medium-sized enterprises**

The definition of small and medium-sized enterprises (SMEs) varies across government agencies and the finance sector. Treasury submitted to the Parliamentary Joint Committee on Corporations and Financial Services:

> There is no single universally accepted definition of a small or medium-sized enterprise. A variety of definitions are used by industry participants. These are generally based on the size of a business's annual turnover, number of its employees, the size of its borrowings, or a combination of these characteristics. (PJCCFS 2011, p. 2)

For example, within the Westpac group SMEs are defined as businesses with up to $1 million in business lending and up to $2 million in total borrowings. St George Bank defines SMEs as businesses with lending of up to $1 million and annual turnover between $1 million and $5 million. The National Australia Bank defines 'small business customers' as businesses with annual turnover between $1 million and $5 million, and 'medium business customers' as businesses with annual turnover between $5 million and $50 million. Other Australian financial institutions adopt different definitions of SMEs.

The definition of SMEs also varies across the Australian Government. For example, to be eligible for small business tax concessions, a business must have annual turnover of less than $2 million. Alternatively, the *Fair Work Act 2009* (Cwlth) defines 'small business employer' as an employer that employs fewer than 15 people. The Treasury definition of SMEs is based on total business income. AusIndustry's Enterprise Connect program for SMEs provides assistance to businesses with annual turnover between $2 million and $100 million. For the purposes of its Export Market Development Grants scheme, Austrade defines an SME as an exporter with annual revenue of less than $50 million.

The ABS uses a number of criteria to define export business size:

- small exporters — having fewer than 20 employees and estimated annual goods and services tax (GST) turnover range of less than $1 million and exports of less than $1 million annually

(Continued next page)

Box 2.4 (continued)

- large exporters — having 200 or more employees or estimated annual GST turnover range of $20 million or more or exports of $20 million or more annually
- medium exporters — all businesses other than those defined as small or large.

The Australian Securities and Investment Commission also uses multiple criteria to assess company size, defining a company as a large proprietary company if it satisfies two of the following three criteria:

- The consolidated revenue of the company and any entities it controls is $25 million or more for the financial year.
- The value of the consolidated gross assets of the company and any entities it controls is $12.5 million or more at the end of the financial year.
- The company and any entities it controls have 50 or more employees at the end of the financial year.

The definition of SMEs adopted by EFIC, of businesses with an annual turnover of less than $150 million, allows EFIC to classify larger businesses as SMEs than the definitions used by other Australian Government agencies and private sector providers. This figure is three times higher than the upper limit turnover figure that the National Australia Bank uses to define medium-sized businesses.

Sources: ABS (2011c); ASIC (2010); ATO (2011a); AusIndustry (2009); Austrade (2012); PJCCFS (2011).

EFIC maintains a treasury operation that it uses to facilitate borrowing on domestic and international capital markets to fund its origination activities, structure Australian dollar and foreign currency cash flows arising from transactions, and manage EFIC's investment portfolio of capital and reserves. EFIC states that the treasury operation is managed to minimise the cost of funding origination activities and to maximise the return on its investments (EFIC 2011a).

EFIC's exemption from competitive neutrality arrangements

EFIC derives financial benefit from government ownership. EFIC's establishment was funded through an initial government injection of funds that forms part of EFIC's capital base. Under the EFIC Act, the Australian Government guarantees payment to all EFIC's creditors (although this guarantee has never been called). EFIC also has access to $200 million of callable capital payable by the Commonwealth.

EFIC is exempt from the Australian Government's competitive neutrality arrangements for all its current activities[4]. Consistent with this exemption, the EFIC Act exempts EFIC from paying income tax and a number of other taxes, although EFIC is subject to the Goods and Services Tax and Fringe Benefits Tax. It is also not required to achieve a particular rate of return or pay a debt neutrality charge to offset the competitive advantages provided by the government guarantee. EFIC is not subject to the Australian Prudential Regulation Authority's requirements, although it states that it voluntarily adheres to some of the Authority's prudential standards (EFIC 2011a).

EFIC's client base

In 2009-10, EFIC provided 54 facilities to 41 exporting firms on the CA. In the same financial year, there were about 45 000 goods and services exporting businesses in Australia (ABS 2011c). Productivity Commission estimates based on unpublished EFIC data indicate that it has provided 458 facilities over the past 10 years to approximately 180 separate clients on the CA. EFIC's clients operate in a number of export sectors, including mining, manufacturing, construction, and ship building and operation (figure 2.1).

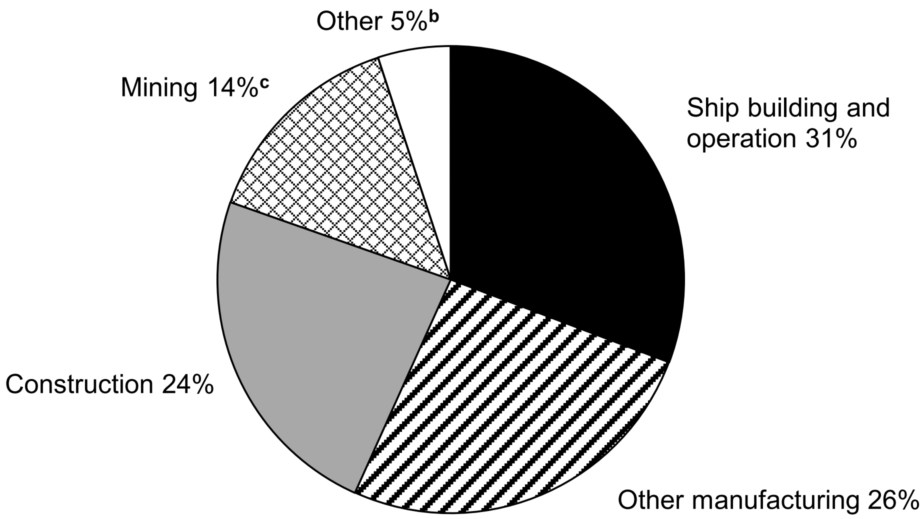
EFIC also assists SMEs on the CA. In 2010-11, 90 facilities were signed with SMEs with a face value of about $135 million. In its 2011 annual report, EFIC noted strong demand for traditional SME products, such as working capital guarantees (EFIC 2011a).

EFIC's annual reports show EFIC often engages the same firms in repeat transactions on its CA over several years. McConnell Dowell, for example, had eleven approved facilities with a total face value of more than $137 million between 2004 and 2011. Ship builder Incat had four facilities approved between 2002 and 2011. EFIC's annual reports indicate that between 2002 and 2011, four firms received EFIC's assistance more than 10 times with one entering into 21 transactions with EFIC since 2009-10.

4 EFIC is subject to competitive neutrality arrangements in respect of its (now divested) short-term credit insurance business.

Figure 2.1 **Principal recipients of EFIC's facilities**[a]

Face value of commercial account facilities, 30 June 2011



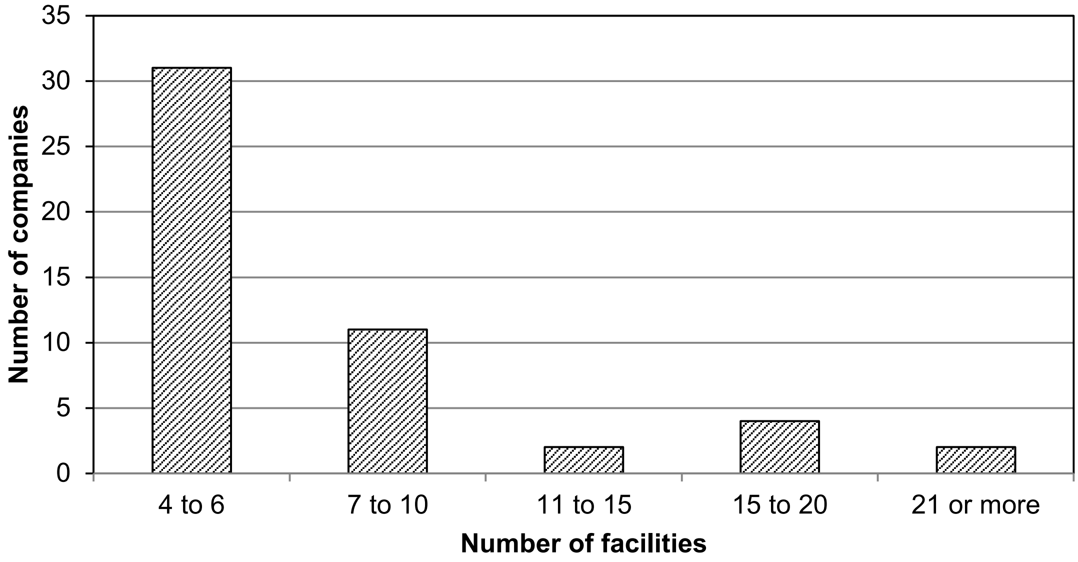
[a] Facilities outstanding include the face value of loans, guarantees, insurance and bonds. [b] 'Other' includes agriculture, forestry and fishing; wholesale trade; financial and insurance services; information media and telecommunications; professional, scientific and technical services; and rescheduled debts to the governments of Egypt and Indonesia that could not be classified. [c] Mining includes contract mining.

Data sources: EFIC (pers. comm., 2 December 2011); Productivity Commission estimates.

According to Productivity Commission estimates based on unpublished EFIC data, EFIC provided facilities to 271 unique firms between 1992 and 2011. Of these, EFIC provided 221 firms with between one and three facilities, while 50 firms were provided with four or more facilities (figure 2.2). However, firms with four or more facilities with EFIC accounted for 53 per cent of EFIC's total CA transactions by number between 1992 and 2011. EFIC suggested to the Commission that:

> … [the Commission's] analysis [of EFIC's transactions over the period 1992 to 2011] is skewed by the divestment of EFIC's short-term trade insurance business in 2003. Focussing on transactions post-2003, EFIC has supported 30 companies with four or more transactions … (sub. DR90, p. 81)

Figure 2.2 **Number of firms EFIC provided with four or more facilities[a, b, c]**
Commercial account, 1992–2011



[a] Excludes companies with three or fewer transactions. [b] Some assumptions have been made about the relationship between corporate entities. [c] All transactions, including assistance to a buyer.

Data sources: EFIC (pers. comm., 3 November 2011); Productivity Commission estimates.

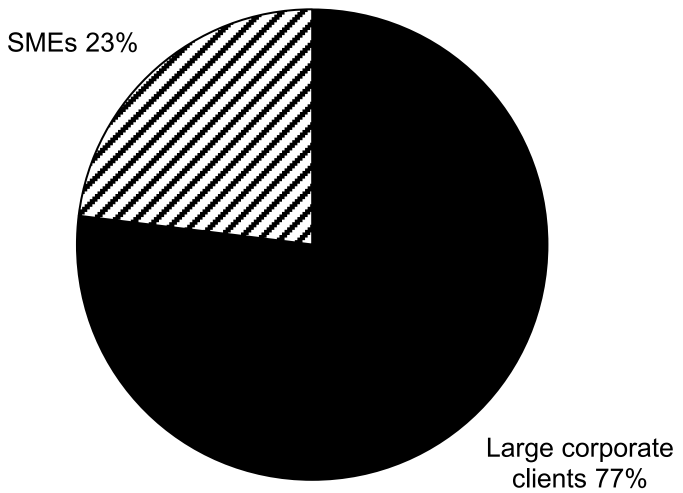
However, the Commission found a similar pattern of EFIC transactions over this shorter time period. Firms provided with four or more facilities accounted for 49 per cent of EFIC's total number of CA transactions over the period 2003-04 to 2010-11.

The history of repeat transactions suggests EFIC's operations are inconsistent with EFIC pursuing a demonstration role for private sector providers and effectively locks in the status quo in export finance and insurance markets. Repeat transactions reduce the incentive for exporters to find alternative sources of finance or alter their business practices.

The majority of the value of the facilities provided by EFIC relate to a small number of large corporate clients. EFIC entered into 11 facilities with large corporate clients (defined by EFIC as having more than $150 million in annual turnover) on the CA with a total face value of more than $450 million in 2010-11. These facilities accounted for more than three quarters of the total face value of EFIC's CA signings that year (figure 2.3). In contrast, EFIC provided 90 facilities to SMEs in 2010-11 but these accounted for 23 per cent of the total value of EFIC CA signings that year (EFIC 2011a). This is despite large companies usually having greater access to private finance options than SMEs (chapter 7).

Figure 2.3 **EFIC signings by business size**[a]

As a proportion of total face value, commercial account, 2010-11



[a] EFIC defines large corporate clients as businesses with more than $150 million in annual turnover and SMEs as businesses with annual turnover of less than $150 million.

Source: EFIC (2011a).

Key financial indicators

The value of transactions entered into by EFIC varies considerably from year-to-year, as does EFIC's operating profit (table 2.2). It is worth noting that where EFIC has recorded an operating profit, these are accounting profits and do not necessarily indicate EFIC is generating an economic profit. An economic profit would require income to exceed reported expenses, including taxes, plus the opportunity cost of funds. The opportunity cost reflects the benefits forgone by taxpayers from having their funds used by EFIC compared to alternative activities such as education and health. Chapters 6 and 8 contain further analysis of EFIC's pricing strategies and financial performance.

Profits on the CA are either returned to the Australian Government as dividends or retained by EFIC to increase the size of its capital base. As directed, EFIC paid a dividend of $28.7 million for the year ending June 2010, representing 75 per cent of the CA profit for the preceding financial year (EFIC 2011a). EFIC paid about $75 million in dividends over the period 2006-07 to 2009-10. The Australian Government made an allowance for a special dividend of $200 million to be paid from EFIC's capital and reserves in the 2012-13 Budget (Australian Government 2012).

Table 2.2 **Key financial indicators**

2007–2011

	Units	*2006-07*	*2007-08*	*2008-09*	*2009-10*	*2010-11*
Face value of new facilities signed	$million	554	369	577	971	593
Operating profit **CA**[a]	$million	40.7	19.7	33.6	38.3	30.2
Dividend[b]	$million	20.4	9.8	16.8	28.7	..
Equity[c]	$million	359.8	331.2	376.7	407.6	408.1
Return on average equity **CA**	%	11.9	5.7	9.5	9.8	7.4
Operating profit **NIA**	$million	70.4	4.8	-0.2	9.4	7.7

a EFIC does not pay tax on its profits. **b** Paid the following year. **c** At end of financial year (not including $200 million callable capital). **CA** commercial account. **NIA** national interest account. **..** Not applicable

Source: EFIC (2007–11; pers. comm., 12 October 2011).

Commercial account and national interest account exposures

EFIC reported exposures (before provisions) of $961 million on the CA and $686 million on the NIA at 30 June 2011 (EFIC 2011a). However, around 75 per cent of total NIA exposures are loans made under the Australian Government's aid-supported mixed credit program, the Development Import Finance Facility. This facility was discontinued in 1996 (EFIC, sub. DR90). These loans include all NIA exposures to Indonesia ($492 million), China ($25 million) and the Philippines ($8 million) (table 2.3). The largest non-aid supported exposures on the NIA are to Egypt, the United States and Papua New Guinea.

The Australian Government reported a total contingent liability in relation to EFIC of $3.4 billion at 31 March 2012. The $3.4 billion contingent liability comprises EFIC's liabilities to third parties ($2.7 billion) and overseas investment insurance, contracts of insurance and guarantees ($0.7 billion). Of the total contingent liability, $2.8 billion is held on the CA and the remaining $0.6 billion on the NIA (Australian Government 2012).

Table 2.3 **National interest account exposures by country**

30 June 2011

	Value	*Share of total*
	$million	%
Indonesia[a]	492.3	71.8
Egypt[b]	101.2	14.8
United States	28.5	4.1
China[a]	24.6	3.6
Papua New Guinea	15.8	2.3
Cuba	9.7	1.4
Philippines[a]	7.6	1.1
Australia	4.5	0.7
Japan	1.5	0.2
Total	**685.7**	**100.0**

[a] Development Import Finance Facility exposure. [b] In the mid-1980s EFIC paid credit insurance claims on exports to Egypt. These debts were subject to rescheduling through the Paris Club. Egypt has paid all amounts due under the rescheduling in full and on time. The balance of rescheduled debts owed by Egypt is $101 million.

Source: EFIC (2011a).

EFIC in a broader context

EFIC operates within the context of other Australian Government programs to assist exporters and an international network of ECAs.

Australian trade policy

Australia has reduced its own barriers to international trade mainly through domestic industry assistance reform initiatives, reinforced by participation in multilateral trade agreements. Australia has derived substantial economic benefits from the trade liberalisation process with the gains from unilateral liberalisation dominating external trade policy considerations (Banks 2010). More recently, Australian governments have entered into bilateral trade agreements (PC 2008). As the Commission has previously stated:

> … contrary to mercantilist notions that focus on export promotion and market access and often cloud debates about trade policy, the main benefits that arise from trade liberalisation result from a country purchasing its inputs and final goods from the lowest cost sources of supply, and exposing its industries to greater import competition by reducing its own trade barriers. (PC 2010b, p. xxvi)

Government services and programs for exporters

The Mortimer Review of export policies and programs noted the importance of program coordination at all levels of government, and between government and business, to meeting trade and investment objectives (Mortimer 2008).

In addition to the services provided by EFIC, the Australian, state and territory governments provide a range of financial and advisory products and services that directly assist exporters (box 2.5). The coverage of this assistance is highly concentrated in the manufacturing sector and only a fraction of exporters receive this assistance. There is also a number of Australian Government programs that offer financial assistance to businesses in general, including those involved in exporting. Receiving financial support from these programs does not preclude businesses from accessing EFIC's services.

The Commission estimates that the gross value of budgetary assistance to industry provided by the Australian Government was about $9 billion in 2010-11. It is estimated that about 6 per cent, or $522 million, was export assistance (PC 2012). Assistance provided by state and territory governments is in addition to this amount.

EFIC's relationship with Austrade

Austrade is the Australian Government's international trade, education and investment promotion agency. The Minister expects EFIC to work closely with Austrade in a coordinated approach to delivering services to Australian businesses (Emerson 2011). Austrade and EFIC have worked together on particular issues, for example, in the development of products, and on individual business opportunities such as the sale of fast ferries to Europe. Austrade also supports EFIC by sharing information such as economic analysis, risk management perceptions, and trade and investment research (Austrade, sub. 14).

EFIC and other export credit agencies

EFIC participates in international associations and forums of export finance and insurance providers. These include the Berne Union (box 2.3) and the Asian Exim Banks Forum (a forum of Asian ECAs). These arrangements seek to encourage cooperation between members and provide a forum in which members can exchange information about international trade, and develop and promote improved governance and transparency in export finance.

Box 2.5 Other government assistance and programs for exporters

In addition to EFIC's activities, Government assistance to exporters is provided through:

- other Australian Government direct export assistance programs including the Clean Energy Trade and Investment Strategy
- Austrade and Tourism Australia
- Australian Government general assistance programs to businesses that provide tariff concessions, training assistance, information and advice, and start-up assistance
- state and territory government initiatives including trade missions and direct financial assistance.

Australian Government *direct* financial assistance for exporters is estimated at $522 million in 2010-11. This does not include direct financial assistance provided through export-related programs by state and territory governments or the value of general assistance programs that benefit exporters. Importantly it does not include assistance by way of the Australian Government's Enhanced Project By-law Scheme (EPBS), which provides tariff duty concessions to large projects having an approved plan to use local suppliers.

Australian Government direct financial assistance that is specific to exporters comprises:

- the Export Market Development Grants (EMDG) scheme — businesses with annual turnover of up to $50 million can apply for up to seven grants to partly reimburse expenses incurred in promoting exports. The latest figures available show about 95 per cent of recipients had annual turnover less than $20 million
- Tradex — provides a cashflow benefit for importers who intend to export goods by exempting them from the relevant duty at the time of import
- the Duty Drawback Scheme — enables businesses to obtain a refund of Customs duty paid on imported goods where those goods will be treated, processed, or incorporated into other goods for export, or are exported unused since importation.

The Australian Government also provides general business support:

- Commercialisation Australia — a competitive, merit-based assistance program offering funding and resources to accelerate the business building process for eligible Australian companies and entrepreneurs

(Continued next page)

Box 2.5 (continued)

Australian Government direct funding for export programs, 2010-11[a]
$ million

Industry	*EMDG*	*Tradex*	*Duty Drawback*	*Total funding*
Primary industries	3.8	0.3	–	4.1
Mining	1.4	0.3	–	1.7
Manufacturing	47.6	33.9	74.5	155.9
Services industry groups	90.3	4.7	–	95.0
Total all industries	**143.1**	**39.2**	**74.5**	**256.7**

a Totals may not add due to rounding.

- Supplier Access to Major Projects — a program that helps Australian industry participate in major Australian and international projects by providing funding to assist research and identification of capable Australian suppliers. The program is funded through the Department of Industry, Innovation, Science, Research and Tertiary Education (DIISRTE).
- Australian Industry Participation (AIP) Plans encourage the use of Australian industry in projects and global supply chains. Companies applying for large Commonwealth grants (generally above $20 million) or other schemes are required to implement an AIP Plan and so provide opportunities for local suppliers. This requirement includes participants in the EPBS. About $230 million in tariff duty concessions was provided to project proponents, including a number of large resource projects, under the EPBS in 2010-11. The Commission was unable to ascertain the proportion of EPBS support provided to exporters.
- A range of Research and Development (R&D) tax concessions is available to eligible Australian companies. These programs include the R&D Tax Concession, Premium R&D Tax Concession, R&D Tax Offset, Venture Capital Limited Partnerships, Early Stage Venture Capital Limited Partnerships and Pooled Development Funds.
- There is a range of programs specifically directed at small start-ups and SMEs that can be utilised by exporters, including:
  - the Small Business Support Line, an AusIndustry program to provide small business owners with a single point of contact to access information and referral services to help better manage their business
  - Enterprise Connect, a DIISRTE initiative that offers advice and support to eligible SMEs.

(Continued next page)

Box 2.5 (continued)

Most state and territory governments have advisory offices in Australia and overseas to assist exporters, and also organise trade missions and exhibitions for exporters to meet contacts overseas and promote their products. State and territory governments also provide direct financial assistance through export related programs. Some of the assistance packages, by jurisdiction, include:

- New South Wales — the Global Growth program offers an adviser to clients to assist with developing export strategies and grants to help implement those strategies
- Victoria — First Step Exporter offers a grant of up to $10 000 to Victorian companies seeking to research and explore opportunities in their first export markets
- Queensland — the Export Advisory Service works with companies to help them become export ready, select export markets and find overseas business partners
- South Australia — the Gateway Business Program contributes 50 per cent of eligible expenses incurred by exporting businesses in developing their international markets
- Western Australia — the Industry Facilitation and Support Program has a number of objectives including export promotion and contributes 50 per cent of eligible expenditure (up to $25 000) to successful applicants
- Tasmania — the Export Market Assistance Scheme and Springboard To Market Program provide assistance to exporters in their marketing activities
- Northern Territory — the Trade Support Scheme allows Northern Territory based organisations to offset up to 50 per cent of the cost of marketing activities associated with exporting
- Australian Capital Territory — TradeConnect provides grants to help new and existing ACT exporters build global opportunities and enhance their international competitiveness.

Sources: AusIndustry (2009; 2012); Austrade (2012); Business Victoria (2011); DEEDI (nd); Department for Manufacturing, Innovation, Trade, Resources and Energy (2012); Department of Commerce (nd); Department of Economic Development (2012); Department of Economic Development, Tourism and the Arts (nd); Department of the Chief Minister (nd); Department of Trade and Investment (nd); DIISR (2011); DIISRTE (nd); PC (2012).

EFIC has reciprocal risk participation agreements with foreign ECAs (EFIC, sub. 18). These agreements provide a formal process for risk-sharing international projects that have contributions from exporters from more than one country. Under these agreements, the main contractor negotiates credit coverage for the entire transaction with its country's ECA or the ECA of the country with the largest share of the contract (the lead ECA). The lead ECA then arranges support from the ECAs of the sub-contractor countries (follower ECAs).

EFIC has participated in risk-sharing arrangements with foreign ECAs for a number of recent domestic and international projects (table 2.4). For example, in 2010 EFIC supported a liquefied natural gas project in Papua New Guinea with ECAs from China, Italy, Japan and the United States (EFIC 2010a). EFIC has emphasised the role it plays in arranging the participation of other ECAs:

> ... EFIC, with substantial reinsurance from Canada's EDC [Export Development Canada], was able to assist Brookfield Rail access support from a Chinese bank to finance a rail upgrade project for a new iron ore mine in Western Australia; and Santos turned to EFIC and ECAs from Italy and Canada and Malaysia to fill the gap in commercial bank capacity for term debt to finance the development of the Gladstone LNG project. (sub. DR90, p. 8)

Table 2.4 **Projects where EFIC has participated in risk-sharing arrangements with other export credit agencies**

2009–2011

Transaction name	*Participating ECAs*[a]
Gladstone LNG project	EFIC; Servizi Assicurativi del Commercio Estero (SACE), Italy; and Export Development Canada (EDC)
PNG LNG project	EFIC; Export-Import Bank of China; SACE, Italy; Export-Import Bank of the United States; and Japan Bank for International Cooperation
Wiggins Island coal export terminal project	EFIC and EDC
Brookfield rail project	EFIC and EDC

[a] There may be other participating ECAs whose participation has not been made public.

Sources: EDC (nd); EFIC (2010a; 2011e; 2012f); Santos (2011c).

3 Private sector provision of export finance and insurance

Key points

- A large proportion of global trade (about 90 per cent) takes place without assistance from export credit agencies.
- Importers and exporters face many similar risks. Importers, and the vast majority of exporters, successfully use private sources of finance and insurance.
- The Australian and international finance and insurance markets offer a range of products to help importers and exporters manage their cash flow and commercial risks, such as credit risk.
- Most of the products offered by EFIC are offered by the private sector with the differences relating primarily to the terms and conditions, including price, at which the products are offered.
- Transactions that the private sector may be reluctant to accept on the same conditions (or under any conditions) as EFIC include: transactions with small or medium-sized enterprises that have little or poor credit history; transactions involving high-risk or post-conflict countries; and long-tenor transactions.
- Compared to private sector options, EFIC’s provision of export finance and insurance services benefits exporters in several ways, including:
  - supporting transactions the private sector may consider to be too risky due, for example, to a firm’s size or the country to which the firm is exporting
  - more favourable terms and conditions, such as reduced collateral requirements or longer repayment terms
  - allowing firms to forgo the additional costs associated with other sources of finance, such as equity.

This chapter reviews the extent to which the products and services offered by the Export Finance and Insurance Corporation (EFIC) are available in the private sector. An analysis of the extent to which any gaps constitute market failure is presented in subsequent chapters.

3.1 The role of finance and insurance in trade

International trade involves transactions across more than one national legal, political or financial system, exposing importers and exporters to a number of risks (box 3.1). Exporters (or importers) may seek to reduce these risks by transferring them to a third party, which accepts the risk for a fee. Trade finance and insurance products are offered by private sector intermediaries such as banks, insurance companies and government export credit agencies (ECAs), such as EFIC.

However, a large proportion of global trade takes place without the assistance of ECAs.

> Most trade finance does not come from official export credit agencies (ECAs) but rather from the private sector. Approximately 65 to 90 [per cent] of finance is extended between firms in a supply chain relationship or between individual units of the same firm'. (Hufbauer 2011, p. 1)

International trade typically takes place on the basis of cash or short-term credit, without intermediation through financial markets. Up to two thirds of the value of global merchandise trade is organised using either 'open account' or 'cash-in-advance' terms (Asmundson et al. 2011). In these transactions, the buyer and the seller are able to agree on terms to share the credit or country risk without intermediaries, although they may mitigate and manage their risks in other ways (for example, diversifying by selling to a number of buyers across a range of markets).

Where transactions are undertaken on open account terms, the exporter delivers the goods to the buyer without payment, and the buyer is expected to pay on delivery according to the sales contract. Under this arrangement the exporter draws on working (or other sources of) capital and bears much of the credit risk involved in the transaction. For cash in advance arrangements, the buyer is extending working capital to the exporter and bears much of the credit risk.

The Berne Union (2011) estimates that about 10 per cent of world trade is supported by its members, who include public and private sector providers of trade finance and investment insurance. Estimates of the share of world trade supported by ECAs and an estimate of EFIC's share of the Australian market are not available.

Box 3.1 **Risks faced by exporters and importers in cross-border transactions**

Exporters and importers face a number of risks in conducting transactions:

- credit risk — the possibility of a client (either the buyer or seller) defaulting on their obligations by the agreed date. An importer could find that a product they paid for is not delivered as promised in the event that an exporter becomes bankrupt. Guarantees and insurance also give rise to credit risk if the issuer defaults
- country risk — arising from the political situation in the destination or source country. For example, an importer could find that products that have been paid for cannot be delivered on time because of war in the exporter's country
- sovereign risk — arising from policy changes in foreign countries such as expropriation or nationalisation of assets
- market risk — arising from macroeconomic fluctuations such as changes in the exchange rate between the date of the agreement and the receipt of payment
- price risk — the value of the commodity may change between the date of the agreement and date of payment
- tenor risk — several of the above types of risk, for example, country risk or price risk, increase with the duration of the contract. Consequently, long-term contracts are generally more risky than short-term contracts
- product risk — for the exporter, it is the risk that the product sent is not acceptable to the buyer and a warranty is called. For the importer, it is the risk that the goods do not meet their requirements
- operational risk — arising from general business operations, such as fraud.
- transportation risk — to the client, it is the possibility that goods are lost or destroyed en-route
- reputational risk — the client could be subject to negative publicity as a result of involvement in socially, politically or environmentally sensitive projects. For example, a firm importing timber harvested from an environmentally sensitive area may receive bad publicity.

Sources: Grath (2008); Freixas and Rochet (2008).

3.2 Finance and insurance markets

Australia's finance and insurance markets

Finance and insurance is the largest sector in the Australian economy, contributing \$137 billion at current prices or about 10 per cent of GDP in 2010-11 (ABS 2011a; 2011b). For those firms that do require export finance and insurance, Australia has relatively deep and liquid financial markets and is recognised as a regional leader in finance and insurance (AFMA 2011). The Commonwealth Bank noted that:

> … the Australian syndicated and club loan market in 2011 recorded a total loan volume of US$115,667m … The 2011 loan volumes were the highest over the last decade, with the quantum driven by a high level of refinance activity (55% by volume) and significant activity in project financing (>12% by volume). (sub. DR100, p. 2)

The 2011 World Economic Forum's Financial Development Report ranked Australia fifth among the world's financial centres (table 3.1), and second in terms of financial access by individuals and businesses to different forms of capital and financial services. Australia ranked highly in banking (seventh) and ranked second in financial access (access by individuals and businesses to different forms of capital and financial services) (WEF 2011). The most recent Global Financial Centres Index ranks Sydney fifteenth and Melbourne eighteenth among the world financial centres (Long Finance 2011). The four major Australian banks have a Standard & Poor's rating of AA-, indicating that they face a relatively low probability of default (S&P 2011c).

Table 3.1 **Top 10 countries ranked by efficiency of their financial markets**
Based on overall index rating[a]

Economy	*2010 rank*	*2010 score (1 to 7)*
Hong Kong SAR	1	5.16
United States	2	5.15
United Kingdom	3	5.00
Singapore	4	4.97
Australia	5	4.93
Canada	6	4.86
Netherlands	7	4.71
Japan	8	4.71
Switzerland	9	4.63
Norway	10	4.52

[a] Each country is ranked on a range of factors, policies and institutions that define deep and effective financial markets.

Source: WEF (2011).

International finance and insurance markets

Many Australian importers and exporters also access international markets for finance and insurance services. However, international financial markets have faced considerable challenges since the last review of EFIC in 2006.

In particular, events during the global financial crisis (GFC) led to a severe recession in some nations, a sharp decline in world trade volumes and a tightening of credit conditions in the United States and Europe, with flow-on effects for international financial markets (De Michelis 2009). During this period, banks increased the price of finance and collateral requirements, and reduced counterparty exposure limits, to protect against heightened credit risk and to meet regulatory requirements.

Since 2008, banks have been subject to new capital rules under the Australian Prudential Regulation Authority's (APRA) guidelines based on the Basel II framework. While APRA has not yet finalised its response to Basel III, banks may need to increase their collateral to meet requirements designed to improve the stability of the financial system. Some participants to this inquiry noted that stricter capital requirements are likely to increase the price of finance (Clifford Chance, sub. DR52; Australian Institute of Export, sub. DR107).

During the GFC, the repricing of risk was evidenced by larger spreads between BBB-rated corporate bond rates and Australian Government bonds between late 2007 and early 2009. Although the spreads between BBB-rated corporate bond rates and Australian Government bonds increased significantly between 2007 and 2009, the movement in spreads was offset by a fall in bond rates. Figure 3.1 indicates that BBB-rated corporate bond yields fluctuated over the past decade, but have settled at about 7 per cent since 2010.

A number of submissions suggested that private appetite for longer tenor transactions has remained tight since the GFC (Allens Arthur Robinson, sub. DR42; King & Wood Malleson, sub. DR84, National Australia Bank, sub. DR92).

Credit Agricole suggested that in the absence of ECA support:

> Private insurers are very often unable to offer these large durations and with shorter maturities, some investors would be faced with a refinancing risk, considered as unacceptable by lenders; then some projects could not materialize. (sub. DR75, pp. 1-2)

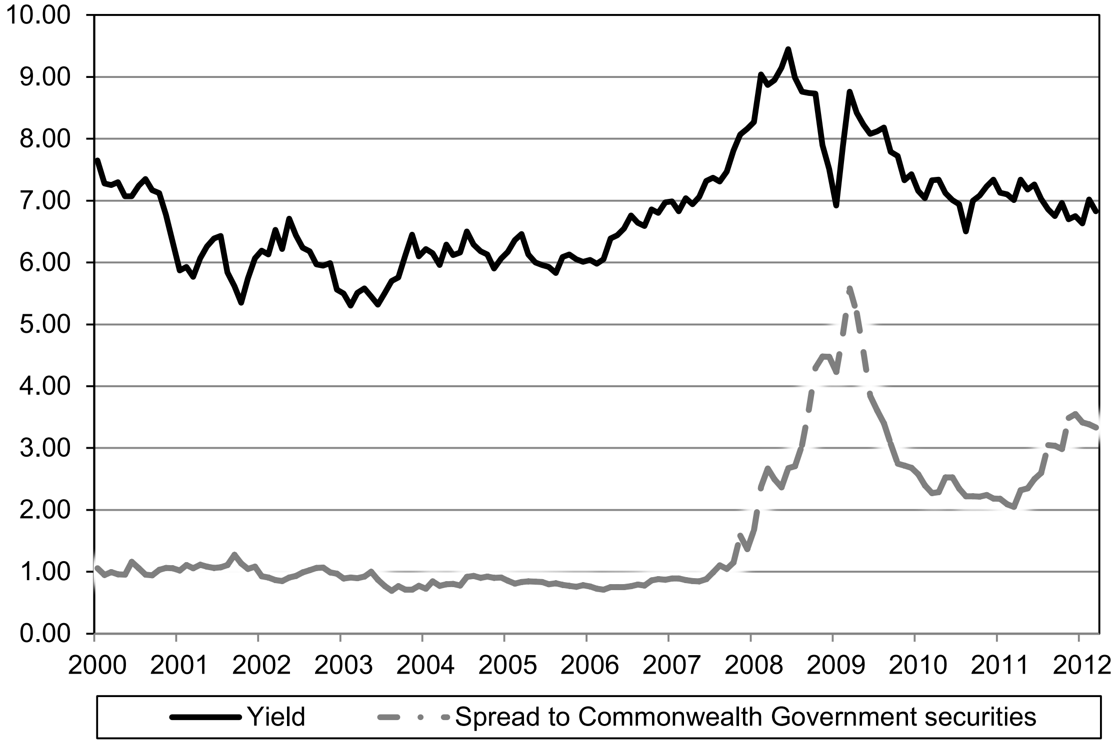
Santos also claimed that:

> … access to financing has been difficult and a number of market participants have been withdrawing ... (sub. DR64, p. 2).

However, there is evidence that shows some firms have been able to obtain long-term finance. This is discussed in section 3.5. A discussion of the impact of the 2008-09 financial crisis on the demand and supply of trade finance is undertaken in chapter 5.

Figure 3.1 **BBB corporate bond yield and spread above Commonwealth Government securities**

1 to 5 year BBB-rated corporate bonds, per cent



Data source: Reserve Bank of Australia (pers. comm., 11 April 2012).

Risk management options for private sector providers

Financial institutions specialise in managing and mitigating risk, using a number of methods to do so (box 3.2). In the private sector, prudential regulation, competitive pressures and profit maximisation give firms strong incentives to adopt sound financial risk management practices, and engage in continuous improvement of their assessment, pricing and controlling of risk.

Box 3.2 **Risk management methods used by financial institutions**

Financial institutions can manage and mitigate risk by:

- diversifying and hedging on an aggregate level — banks and insurance firms can reduce their overall level of credit and market risks by holding a broad range of weakly correlated (and offsetting) assets and liabilities, and by operating in a range of markets
- tightening the provision of finance or insurance — reducing the amount of finance or insurance extended, either in total or to certain borrowers
- reducing aggregate exposure to a project or counterparty by forming syndicates
- reinsuring with insurance firms
- using risk-based pricing — charging higher interest rates or premiums to high credit risk clients
- developing infrastructure — technology and skilled staff to improve the accuracy and efficiency of managing various risks
- following risk management policies — internal rules and procedures governing the provision of credit and insurance
- setting terms and conditions — for example, on the minimum level of collateral held by the borrower, or the terms on which an insurance product may be offered
- enforcing covenants — stipulations on agreements that require, for example, the borrower to:
  - periodically report their financial position
  - refrain from paying dividends, repurchasing shares, borrowing further, or other specific, voluntary actions that negatively affect the firm's financial position
  - repay a loan in full, at the lender's request, in certain circumstances such as a change in the borrower's debt-to-equity ratio
- requiring loan insurance — requiring the applicant to insure against the risk of default.

Sources: Asmundson et al. (2011); Freixas and Rochet (2008).

3.3 Comparison of products offered by EFIC and private providers

EFIC offers a range of products to manage and mitigate the various risks faced by exporters. EFIC's products can be broadly grouped into loans, insurance, guarantees, bonds and research (table 3.2).

Table 3.2 **Products offered by EFIC**

Product	*Description*
Loans	
Direct loan	A direct loan to an exporter or foreign buyer of capital goods
Producer Offset loan	A loan against tax rebates receivable from the Australian Government's Producer Offset scheme (for eligible film, documentary or television production companies)
Funded export finance guarantee	A direct loan to a bank to on-lend to a buyer or exporter
Insurance	
Political risk insurance	Insures lenders, investors or contractors against losses arising from events such as civil unrest and the inability to repatriate funds
Bond insurance	Insures the exporter in the event that a bond is wrongfully called
Credit insurance	Insures the exporter in the event of non-payment by a buyer
Guarantees	
Export working capital guarantee	A guarantee to an exporter's bank for the exporter's payment obligations, when the bank provides the exporter with working capital
EFIC headway working capital guarantee[a]	A guarantee to an exporter's bank for the exporter's payment obligations when the bank extends the exporter's trading limit
Export finance guarantee	A guarantee to the buyer's or exporter's bank for the bank's provision of finance
Documentary credit guarantee	A guarantee to an exporter's bank that a buyer's bank will meet the obligations of a documentary credit payable to the exporter
Foreign exchange facility guarantee	A guarantee to a foreign exchange provider for the exporter's payment obligations, when the foreign exchange provider extends the limit of the exporter's foreign exchange facility
Risk participation agreement	Partially guarantees the financier in the event of non-payment
Reciprocal risk participation agreement	Partially guarantees (or insures) another export credit agencies' risk
Bonds[b, c]	
Advance payment bonds	Compensates the buyer for funds advanced to the exporter in the event of non-completion of the contract
Performance bonds	Compensates the buyer in the event the exporter fails to honour its obligations under the contract
Warranty bonds	Compensates the buyer in the event the exporter's goods do not meet contractual warranty obligations after a project is complete
US bonding line	Compensates the buyer in the event of non-performance by the exporter. Provided under an arrangement with a registered US surety bond provider
Research	
Country profiles	Information on the risks of doing business in various countries
World risk developments newsletter	Monthly newsletter summarising global economic developments
Economics chartpack	Monthly summary of world economic conditions

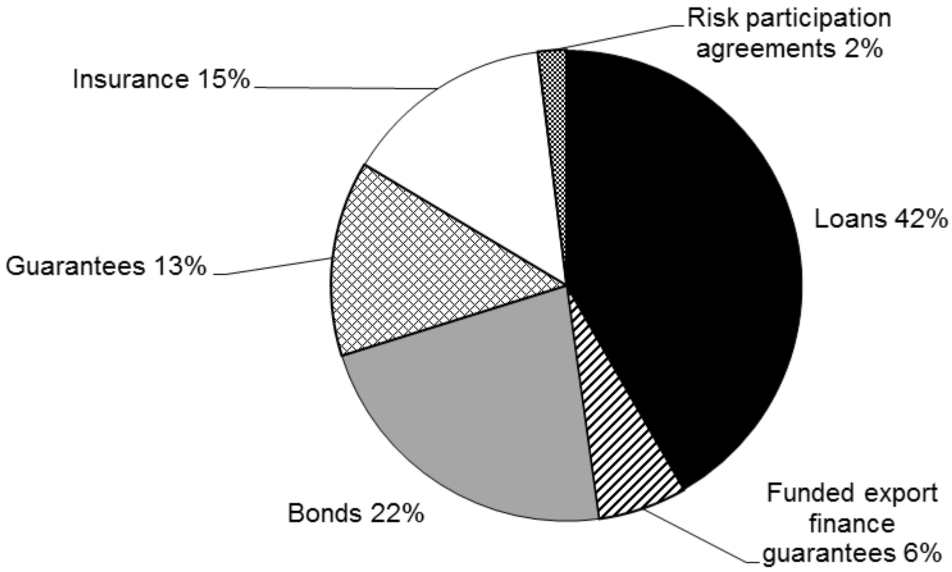
[a] The EFIC headway working capital guarantee was discontinued in December 2011. [b] The bond products offered by EFIC fall within the definition of 'guarantee' under s. 3(1) of the *Export Finance and Insurance Corporation Act 1991* (Cwlth). [c] EFIC can provide a bond directly to the buyer on the exporter's behalf or provide a guarantee as security to a bank, which in turn provides the bond to the buyer.

Sources: EFIC (2011a; pers. comm., 13 April 2012).

Over the past five years, loans have made up the largest proportion (by value) of EFIC's products, followed by bonds and guarantees (figure 3.2).

Figure 3.2 **EFIC's commercial account facilities**

Share of total value, by product, 2006-07 to 2010-11



[a] Based on the face value of signings in each year and is not equivalent to EFIC's exposure at 30 June 2011.
Sources: EFIC (2006; 2007; 2008a; 2009a; 2010a; 2011a).

Loans

EFIC provides direct loans to buyers and exporters for the purpose of financing eligible export transactions. A funded export finance guarantee is a loan from EFIC to a financier, who then on-lends to foreign buyers or exporters. EFIC has increased its provision of funded export finance guarantees since they were first offered in 2009. At 30 June 2011, it had exposure of about $117 million to this product (EFIC 2011a).

The Producer Offset loan allows eligible producers of Australian films, documentaries and television programs to obtain cash flow against their anticipated producer offset tax rebate.

Direct loans

EFIC has claimed that the private sector is less willing to provide longer tenor loan products:

> In normal market conditions, the private sector has ample appetite and capacity to support borrowers' needs with tenors of up to five years. During the GFC, in Australia, this tenor appetite was reduced in the syndicated loan market. Beyond that five year horizon, financial transactions tend to be more highly structured, and often related to asset- specific or project finance. This is the market segment in which export credit agency … financing is more prevalent, as fewer private market participants have the risk appetite for such assets. (sub. DR90, pp. 14-15)

A large proportion of EFIC's loan book is long-term debt. For example, EFIC provided a $50 million direct loan over a ten year period to Orica Limited, the world's largest supplier of commercial explosives, to construct an ammonium nitrate manufacturing plant in Indonesia (table 3.3). Orica was able to obtain a loan from EFIC that matched their requirements at a time 'when the commercial market [had] limited appetite for longer tenor financing' (EFIC ndo).

However, long-term debt can be obtained from a variety of private sector sources including international and domestic banks, retail investors, traded and untraded bonds, national and international banking syndicates and superannuation funds (Icon Group International Inc. 2007). Shorter-term loans obtained from the private sector may also be refinanced on maturity.

Producer Offset loan

The Australian Screen Production Incentive (ASPI) is an Australian Government incentive program to promote film, television and other screen production. The Producer Offset is one of three streams under ASPI that provides a 40 per cent tax offset[1] on qualifying Australian production expenditure on a feature film and a 20 per cent tax offset if the film is not a feature film (Screen Australia nd).

EFIC has established a loan program to finance recipients of the Producer Offset tax rebate to support Australian films, documentary and television productions with international distribution agreements (Screen Australia, sub. DR46; EFIC, sub. DR90). The loan program provides cash flow to assist production funding by providing upfront access to funds, and bridging the funding gap between the incidence of production costs and receiving the Producer Offset (EFIC ndp).

1 Tax offsets directly reduce the amount of tax the individual or company must pay. Each dollar of tax offset reduces the tax payable amount by a dollar, regardless of the taxable income (ATO nd).

Table 3.3 **EFIC's commercial account loans**

2006-07 to 2010-11

Primary counterparty	*Project description*	*Project country*	*Maximum tenor[a] (years)*	*Value (A$ mil)[b]*	*Share of all loans (%)*
2006-07					
Lumwana Mining	Copper mine	Zambia	9.0	54.5	7.8
B&N Bank	Supply, install banking software	Russia	6.6	3.8	0.5
2007-08					
Emirates Aluminium	Aluminium smelter & power supply plant	UAE	16.1	142.8	20.4
2008-09					
Lumwana Mining	Copper mine loan increase	Zambia	7.0	12.8	1.8
Leighton Holdings	Mining equipment leases	Indonesia	6.0	202.2	28.9
2009-10					
ExxonMobil PNG LNG Services[c]	Liquefied natural gas project	Papua New Guinea	17.0	109.5	15.7
African Underground Mining Services	Finance new equipment	Mali/Ghana	3.7	16.2	2.3
Orica Limited	KNI Project — ammonium nitrate plants	Indonesia	9.9	51.3	7.3
2010-11					
Rock Island Production	Film production producer offset	Australia	0.5	0.5	0.1
Who-Four	Film production producer offset	Various	1.9	0.5	0.1
Mindful Films	Film production producer offset	Various	0.6	0.1	0.0
Danske Faerger A/S	High speed catamaran	Denmark	12.4	66.8	9.6
Incat Tasmania	Construction of catamaran	Australia	1.5	37.5	5.4
			10.7	**698.4**	**100.0**

[a] Tenor was calculated as the difference between agreement and maturity dates. However, some loans did not begin drawing down on the agreement date, so the actual tenor will be less than this approximation. [b] A$ value is at the time the facility was signed, and is obtained from EFIC annual reports, except for loans made in 2008-09. The A$ value in 2008-09 was calculated using the average exchange rate for that year (A$1= US$0.74). [c] Facility was shared over the commercial account ($US100 million) and national interest account ($US250 million).

Sources: EFIC (2007–2011; pers. comm., 8 November, 2011).

EFIC has signed contracts with the producers of the movie *Satellite Boy* (2012), the telemovie *Panic at Rock Island* (2011), the documentary series *Who Do You Think You Are* (2012) and *Outback Fight Club* (2011) (EFIC 2011a).

EFIC noted in a submission to a review of the Australian Independent Screen Production Sector that in 'some cases banks and other financial institutions may support a production, however, they may require additional property security and pre-payment of interest' (EFIC 2010c, p. 1). Private finance providers and some state government organisations offer finance to recipients of the Producer Offset tax rebate. In addition to those in table 3.4, private providers such as Aver Media, Fulcrum Media Finance, National Bank of California and Abacus Film Fund are listed on the Screen Australia website as also offering cash flow facilities or brokered finance for Producer Offset applicants (Screen Australia nd).

Table 3.4 **Provision of finance against the producer offset tax rebate**
Private and government providers

Provider	*Product offering*[a]
Private providers	
IFS Capital Limited	Up to 80-90 per cent of anticipated producer offset tax rebate with a minimum size of $1 million
Media Funds Management	90 per cent of the anticipated producer offset tax rebate at the lower end of the market
Chesterfield Offset Finance	Provides up to 90 per cent of the anticipated producer offset tax rebate
Government providers	
Film Victoria	Up to 85-90 per cent of anticipated producer offset tax rebate. Limit of $3 million per project
Screen Queensland	Support is capped at the lesser of $6 million per project or 50 per cent of the project’s budget
Screen NSW	Provides loans up to $100 000.
South Australian Film Corporation	A $3 million financing facility to assist projects by obtaining cash flow from the producer offset tax rebate

[a] Terms and conditions of product offering may be different to those offered by EFIC.

Sources: Chesterfield Offset Finance (nd); IFS Capital (pers. comm., 3 April 2012); Film Victoria (nd); Media Funds Management (nd; pers. comm., 3 April 2012); Screen Australia (nd); South Australian Film Corporation (nd); Screen NSW (sub. DR91); Screen Queensland (nd);.

Screen Australia also noted that several banks and financial institutions provide offset loan facilities to production companies, although smaller transactions were ‘not of particular interest to the banks and larger finance companies’ (sub. 17, p. 2).

Other participants to this inquiry noted the importance of the Producer Offset scheme to the Australian film and television industry and that ‘EFIC’s loan facility helps to maximise the intended benefit of the Producer Offset legislation ... ’ (Screen Producers Association of Australia, sub. DR55, p. 2). The Commission has been advised that at the time the Producer Offset scheme was introduced by the Government, it was not envisaged that EFIC would be a participant in the scheme.

EFIC noted that the initiative they took with Screen Australia:

> … literally came about from a conversation where the chairman of Screen Australia was speaking with a film producer and identified the issues that, for smaller-budget features, there was simply a gap that the commercial market wasn't filling, that it was very restricted in the Australian domestic context. So EFIC as a statutory authority does have the ability to be more flexible in taking up these policy concerns and trying to respond to them. (trans., p. 139)

Chapter 10 provides a discussion of EFIC's future role in the Producer Offset scheme, based on market failure rationale.

Insurance

Insurance is a risk management tool that offers compensation for a specified event. EFIC products include political risk insurance, bond insurance and credit insurance.

Insurance brokers, such as Alliance Insurance Services Pty Ltd, Aon Corporation Australia Limited and PSC Insurance Group (a member of the Wells Fargo Global Broker Network), facilitate exporters' and importers' access to products underwritten by multi-national insurance companies (Aon Australia 2012; NIBA 2012; PSC Insurance Group 2012).

Many of the insurance products offered by EFIC appear to be offered by private sector insurance brokers (box 3.3). As with direct finance, there may be differences related to the terms and conditions, including price, on which insurance products are offered.

Political risk insurance

Political risk insurance (PRI) provides compensation for policy holders for specific country or sovereign risk events that result in financial loss. These events may include forced abandonment of a product due to a war in the foreign country or the nationalisation of assets such as foreign investments in infrastructure. The exact events covered, and the definition of those events, varies from contract to contract. In addition to providing compensatory value in the event of claims, PRI can help investors access finance or obtain better terms and conditions.

Box 3.3 **Insurance brokers**

A number of insurance brokers offer services specifically aimed at exporters, such as Atia Insurance Services, Jardine Lloyd Thompson, Marsh Australia, National Credit Insurance Brokers and Strathearn Insurance Brokers. The National Insurance Brokers Association has an online tool for finding a broker based on locality and services offered including export-related insurance products.

Brokers fulfil important functions in the market. They reduce transaction costs for their clients by matching buyers and sellers across disparate locations and sources, and reduce the costs associated with searching for information about insurance products.

The widespread existence of brokers suggests that their expertise is valued by market participants and that the market for export insurance products is sufficiently developed to create a demand for these services. There are about 800 insurance broking firms in Australia, ranging from multinational brokers to small businesses employing less than 10 people.

Source: NIBA (2012).

Political risk insurance encourages investment in emerging markets by transferring risk from investors to the insurers' shareholders, in EFIC's case, the Australian Government. For example, EFIC recently provided Orica with PRI to protect its investment in an ammonium nitrate plant in Indonesia (EFIC 2011a).

Political risk insurance is provided by large firms on a case-by-case basis and at times, certain countries (such as Iraq) may be deemed too risky for coverage (Atradius pers. comm., 6 May 2012). Private sector providers are willing to consider a range of transactions, including some high risk propositions, however, the terms and conditions of cover and premiums will reflect the risk of the transaction.

Many insurance companies offer political risk insurance in the Australian market including Atradius, Chartis, Coface and Euler Hermes (Allianz) (Atradius nd; Allianz 2011; Chartis Insurance nd; Coface ndb). Euler Hermes (Allianz) stated that it provides large export firms with a full range of products to cover exporters against country or sovereign risk events (Allianz 2011; Euler Hermes 2010). EFIC noted that:

> Today, comprehensive 'non-honouring of sovereign obligation' policy is commonly available from almost all specialist political risk and trade credit insurers, albeit only a small number have the ability to offer long tenors in excess of ten years … Now political risk insurance represents a small and infrequent portion of EFIC's business. (sub. 18, appendix A, p. 29)

Bond insurance

Bond insurance protects the exporter in the event that an advance payment or performance bond is wrongly called. Buyers may require the exporter to provide a performance bond if they make an upfront payment. For example, if the exporter is unable to fulfil their contractual obligations due to political unrest in the buyer's country, the buyer may demand payment on the performance bond. Bond insurance can reduce the exporter's financial losses, provided that the buyer has met the obligations under the insurance policy. It is uncommon for EFIC to enter into this type of transaction (EFIC 2011a).

Bond insurance is also available through private sector providers such as HSBC and Winley Insurance Group (HSBC 2012; WIG 2012).

Credit insurance

The vast majority of credit insurance, also known as export payments insurance, is provided on short-term contracts (Morel 2011). EFIC no longer provides short-term insurance. A past review of EFIC (DFAT 2001) received feedback from private sector insurers that EFIC's provision of short-term credit insurance was crowding out the private sector. In early 2002, EFIC formed an alliance with a private insurance company, Gerling NCM, to provide the opportunity to demonstrate its capacity to meet exporters' needs for short-term insurance (DFAT, pers. comm., 8 May 2012). Following a DFAT review, the Government decided to divest the short-term insurance business to Gerling NCM (later renamed Atradius) in August 2003.

Consequently, EFIC only offers credit insurance if the export contract has a payment period of more than two years. Where the availability of long-term cover from the private sector is limited, cover for an extended tenor may still be provided (possibly at a higher cost to the exporter) through continuous renewal of a short-term policy (Coface nda).

In 2005, EFIC offered medium-term payments insurance as part of its contract to Thales, which provided air traffic management systems to Aeronautical Radio of Thailand Ltd (EFIC 2005). If Aeronautical Radio of Thailand Ltd defaulted on its payments due to a commercial or political event defined in the export payments insurance policy, EFIC would provide compensation to Thales.

Guarantees

A guarantee is an enforceable promise by a third party that an exporter, buyer or financial institution involved in the export contract will meet its obligations. EFIC offers guarantee products to financial institutions, exporters and overseas buyers.

Recent examples of guarantees issued by EFIC include:

- $2.7 million working capital guarantee to assist Westpac in providing a working capital loan to Ferra Engineering Pty Ltd (EFIC ndj; sub. 18)
- $3.8 million export finance guarantee provided to National Australia Bank to facilitate the provision of working capital to Parnell Manufacturing Pty Ltd, a manufacturer of veterinary pharmaceuticals (EFIC 2011a)
- a documentary credit guarantee to Westpac, the exporter's (GP Graders) bank, to guarantee payments due from the buyer's Turkish bank under a $673 000 letter of credit (EFIC nde).

The foreign exchange facility guarantee is provided by EFIC to a foreign exchange provider. The guarantee encourages the foreign exchange provider to increase their hedging limits for exporters (EFIC 2011g).

Many of the guarantees offered by EFIC have close substitutes available from private sector providers. For example, Australian banks provide similar products to a documentary credit guarantee. Westpac provides an 'export documentary letter of credit' (Westpac nda) that allows the exporter to obtain finance after the bank is satisfied that the conditions of the documentary credit have been complied with. Similarly, ANZ offers import and export finance and documentary credit products (ANZ nd). Clients can also use credit default swaps to hedge against foreign bank default risk.

Private sector alternatives to the foreign exchange facility guarantee may serve a similar purpose. The foreign exchange facility guarantee allows an exporter to extend its trading limits with a foreign exchange provider (and then hedge foreign exchange risk (box 3.4)).[2] This is similar to an extension of working capital by a bank to an exporter, although the terms and conditions of provision, such as collateral requirements, will be different. For example:

> … you don't need to provide security for a foreign exchange facility guarantee from EFIC. This can help to free up your working capital to take on further export contracts. (EFIC 2011g)

2 EFIC has recently made this available to SMEs (EFIC 2011g).

Box 3.4 **Hedging foreign exchange risk**

Exporters have a range of options for hedging their foreign exchange risks, including:

- foreign currency accounts
- forward exchange contracts
- foreign currency options
- flexible forwards (or tactical forwards) that combine products to hedge exposure within a band of acceptable levels
- foreign exchange swaps (or currency swaps).

Sources: Bank of Queensland (2011); HSBC (nd); St. George (nda; ndb); Westpac (2012a; 2012b; nda; ndb).

Absence of identical private sector coverage for guarantees arises primarily from the nature of EFIC's products, rather than failures in financial markets. By design, they are intended to complement the products offered by the private sector by guaranteeing the creditworthiness of an exporter to a third party. For example, in its guidance on working capital guarantees given to prospective clients, EFIC (ndi) stated:

> ... you may not have the assets — often in the form of real estate — that your bank requires you to provide as security for working capital finance. Your bank may also be reluctant to provide finance for an export contract if it considers that the payment terms of the contract are too risky. If your bank can't assist, EFIC may be able to help you obtain working capital finance from your bank with an export working capital guarantee.

Risk sharing agreements

EFIC participates in risk sharing agreements with financiers. ECAs also assisted each other by entering into reciprocal risk participation arrangements to:

> … jointly finance large projects that are beyond the capacity of commercial lenders or a single export-import bank. (EFIC 2011a, p. 42)

For example, Export Development Canada (EDC) reinsured EFIC's participation in the Brookfield rail project (EFIC, sub. DR90) (box 7.3).

In May 2011, EFIC signed a US$65 million risk sharing agreement with the Asian Development Bank, encouraging exporters to export to Bangladesh, Pakistan and Sri Lanka. EFIC also provides reciprocal reinsurance to ECAs in Belgium, France, Germany, Israel, Japan, Korea, the Netherlands, Sweden and the United States (EFIC 2009d).

EFIC noted:

> Under a typical reinsurance agreement, the lead ECA provides export credit cover, on its usual terms, for an entire transaction. Another ECA, assisting an exporter from its own country who may be a sub-contractor or other party to the transaction, reinsures the lead ECA in relation to that party's involvement in the transaction. The effect is that the second ECA takes on that share of the risk. (2009d, p. 1)

Bonds

The bond products offered by EFIC act as an enforceable promise that the exporter will meet its obligations and are typically provided to the buyer. This may be in the form of a payment directly to the buyer or a guarantee to the exporter's bank, which issues the bond to the buyer. In the case of US bonding lines, EFIC provides an indemnity to Liberty Mutual, which subsequently provides a surety bond to the US buyer. EFIC notes that, with the exception of the US bonding line, the other bonds are available from private sector banks and insurance companies (EFIC 2011a). Although private sector providers issue bonds, they usually require collateral, which may extend to the full value of the contract (Allianz nd; Bank of Queensland 2011; HSBC nd; QBE Insurance nd).

Recent examples of EFIC's provision of bond facilities include:

- bonds worth US$363 000 issued to the Polar Research Institute of China (including an advance payment bond and a performance and warranty bond) on behalf of Environmental Systems & Services Pty Ltd. The exporter was able to supply, install and commission advance satellite tracking stations at the Great Wall research stations in Antarctica (EFIC ndg). Environmental Systems & Services Pty Ltd noted:

  > Without the facilities that EFIC has provided to us we would not have been able to undertake most of these projects in recent years and this would have had a significant impact on our turnover and our capacity to employ staff. (sub. 11, p. 2)

- a performance bond on behalf of GoldPeg International Pty Ltd for 50 per cent of the contract value to a buyer, a dairy cooperative in Europe (EFIC ndl).

Research products

EFIC publishes information on the risks of exporting to particular countries and on developments in the world economy relevant for Australian exporters. It also operates an online tool, Export Finance Navigator. This provides current and potential Australian exporters information on export finance alternatives available in the commercial market and the forms of government assistance, such as grants, tax concessions and EFIC products that may be available to them (EFIC ndh).

The information provided in EFIC's country profiles, world risk developments newsletter, economics chartpack and the global readiness index is also produced by private sector providers. Private sector providers and exporting firms use information from firms like Bloomberg, Standard & Poor's, Moody's Analytics, Fitch Ratings and various brokers, some of which is publicly available. Firms may also conduct research in-house.

Other government agencies, such as Austrade, also conduct research. Austrade provides information to exporters about various countries. There may be differences between the economic information provided by EFIC, which focuses on country risk, and the information provided by Austrade, which the Department of Foreign Affairs and Trade (DFAT) described as 'more in the form of practical, on-the-ground advice about the peculiarities of particular overseas markets and commercial practices' (sub. 19, p. 5). However, Austrade and EFIC both provide general trade facts, statistics and information on a country's business and political environment (EFIC 2012b; DFAT nd). EFIC and Austrade appear to overlap in some of their analysis.

3.4 Difference in coverage between EFIC and the private sector

In its submission on the draft report, EFIC noted that the private sector offers many of the same products:

> EFIC has deliberately set out to make products homogenous with the private sector for many reasons including risk transfer, aiding comprehension and transparency. The homogeneity allows clients to understand and compare complex financial products, and EFIC to work in tandem with private providers. (sub. DR90, p. 14)

It further observed that the differences in coverage relate primarily to the private sector participants being unwilling to accept the risks associated with particular transactions:

> Demand for this support arises for reasons of counterparty, country, asset, market and industry risk; and insufficient private market capacity ... The critical difference in EFIC's coverage relates to the risks that EFIC is prepared to assume on behalf of exporters due to an absence of private sector risk appetite and/or capacity ... (sub. DR90, p. 14)

Key aspects of a transaction that affect private sector willingness to enter a particular transaction are discussed next.

Tenor

EFIC is willing to support some long tenor transactions that the private sector is unwilling to support (EFIC, sub. 18; sub. DR90). ANZ, for example, noted that financial institutions are generally unwilling to extend business credit beyond five to seven years due to refinancing risks (sub. 20). Similarly, Commonwealth Bank of Australia (sub. DR100) and Investec Bank PLC (sub. DR72) suggested that there was limited supply of finance from private sector providers for long-term natural resources and infrastructure projects.

A recent example of EFIC's support through a long-tenor facility is the EUR48 million, 12 year loan to assist Danske Faerger finance the purchase of ferries from Australian ship builder Austal (EFIC 2011a).

Country

EFIC provides products to countries such as Pakistan, where 'large macroeconomic imbalances and political instability mean that the risks for exporters and investors range from high to extreme' (EFIC 2012b). A number of participants suggested that banks were unwilling to support business in the developing world (Wagner Group Holdings Pty Ltd, sub. DR31; Allens Arthur Robinson, sub. DR42; Mono Pumps (Australia) Pty Ltd, sub. DR54; Codan Ltd, sub. DR65). McConnell Dowell noted that it:

> … has benefitted from the use of EFIC services directly in relation to construction projects in Mozambique, Laos, Singapore and Papua New Guinea. EFIC has helped provide insurance and bonding facilities for projects in these countries and other countries and thereby helped us win and execute the projects. Our view is that finding these services in the market would have been difficult and could have jeopardized our chances of winning the projects. (sub. DR29, p. 1)

Client type and size

The private sector may refuse some transactions on the terms required by the exporter because of the nature of the exporting firm. EFIC provides some support to smaller, newer and generally riskier firms for which the private sector has 'limited appetite' (ANZ, sub. 20, p. 4). Financial institutions may be unwilling to support transactions with small firms on the same terms that EFIC provides. For example, they may require more collateral (EFIC 2011g). Emtivac Engineering Pty Ltd noted that it expected to:

> … require assistance from EFIC for cash flow and project bonds on larger contracts over $1 million in value. Without the support of EFIC we would be unable to bid for these contracts as bank finance is not available to us without 100% cash or property security. (sub. DR77, p.1)

For transactions with large firms, financial institutions may have internal counterparty limits that constrain their aggregate risk exposure (this was the reason given for EFIC's assistance to Leighton Holdings in 2008-09) (EFIC 2011a; Thiess Pty Ltd, sub. DR50). The Commonwealth Bank suggested:

> … each bank's capacity to lend is limited by prudential and internal limits on single exposures, aggregation policies (including across subcontractors, equity investors, individual projects which share common probability of default). (sub. DR100, p. 3)

Private sector providers will base their decisions on whether to accept a particular transaction on the expected return and risk of the transaction. They are unlikely to provide services that are not expected to make a return commensurate with the transaction's risk.[3] As discussed earlier, private sector providers and exporters also have various means of managing the risks at the source of the above constraints. For example, the tenor of a loan can be extended through refinancing, whereas counterparty constraints of financial institutions can be addressed through syndication with other providers.

There is considerable overlap between financial products offered by the private sector and by EFIC on the commercial account, but the terms and conditions, including price, on which these products are offered may be different. There may be sound commercial reasons for private providers asking a high price for some facilities, or not wanting to service some markets or clients. However, this is not sufficient to indicate that financial markets are failing (discussed in chapter 4).

3.5 Alternatives to using export finance and insurance products

Limited availability of export finance or insurance for certain firms does not necessarily prevent them from proceeding with commercially viable export transactions. Alternatives may be available, however, they may be more costly than receiving support from EFIC.

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3 A possible exception is an expected long-term payoff from building relationships with a client or if a client's other activities result in highly profitable transactions.

Alternative methods of finance

There is a number of other options exporters can access in place of export finance, in particular, equity finance and private debt (box 3.5).

Equity raising is a typical means of expanding the capital base of a firm. For example, a growing firm can go through the following stages during its lifecycle:

- sole trader
- partnership
- private company
- public company listed on the Australian Stock Exchange
- multinational public company listed on more than one stock exchange.

At each stage the firm is able to bring more equity investors into the venture.

The way that a firm finances its expansion (using debt or equity) is a private decision based on the risk-return trade-off (Cheulho 2010; Kisgen 2006) but the availability of government support can affect that commercial decision.

Some firms are reluctant to seek additional equity as it dilutes their control with the creation of more shareholders and instead prefer debt or government support.

Approaching a bank for a loan allows a firm to expand, but at some point a bank may limit its exposure to that firm. EFIC has pointed to this as a reason for its intervention. It may be the case that EFIC has supported firms because of a bank's unwillingness to lend when the alternative of equity raising has not been tested. In effect, EFIC is favouring the existing business model of the firm.

EFIC (2008c, p. 5) noted in its submission to the Mortimer Report:

> EFIC helps innovative companies take the next step beyond commercialisation in growing their businesses offshore. Moreover, the Corporation's debt finance facilities ensure that this can occur without dilution of business owners' equity interests.

EFIC's provision of finance and guarantees allows firms to forego costs associated with equity finance, both at the time of a transaction and when planning the firm's capital structure (box 3.5). Although the ability of business owners to avoid the costs associated with raising debt and equity may be considered an advantage by some, those costs — and a share of the risks of the transaction — are potentially being borne by the Australian taxpayer.

That said, equity finance is likely to be more difficult (and expensive) to raise for newly exporting small and medium-sized enterprises (SMEs). For SMEs, markets for equity are informal and fragmented, often depending on family relationships and acquaintances (Seppa 2010).

Box 3.5 **Alternative financing options**

Exporters can use the following methods to obtain finance:

- Retained earnings — profits accumulated by a firm that are not paid out to shareholders as dividends are kept as retained earnings. Those earnings not earmarked for a specific purpose can be used to finance future investment.
- Share issue — a firm may opt to float on the stock exchange, in which case the public is invited to purchase shares. A listed firm can also issue new shares. Common techniques used for raising finance include rights issues, in which existing shareholders receive the right to purchase additional shares, as well as private issues, which occurs when an invitation to purchase shares is restricted to a limited number of investors (often institutional investors, such as superannuation funds).
- Debentures — a type of debt instrument sold to investors for a specified amount and commonly used by larger firms. A firm will pay interest on a debenture at regular intervals and will repay the face value at maturity. Security can be provided in the form of a fixed charge over specified assets that have not already been secured by other lenders.
- Corporate bonds — a form of long-term private debt issued by large firms. They are similar to debentures in that they are sold to investors, who receive a periodic interest payment and the repayment of face value at maturity. A corporate bond is not secured against property, and instead of being issued publicly, is usually placed privately with institutional investors.
- Convertible notes — a hybrid of debt and equity finance. It is similar to a debenture, except that the investor has the option to either receive the face value or purchase shares at a specified price.
- Venture capital — typically used by high risk start-up firms with the potential for strong growth. Venture capitalists often take a significant ownership stake in the firm and can influence management.
- Company structure — an organisation may have various options to change its business structure to obtain equity:
  - For example, a company could form a joint venture — an organisational structure between two or more parties. This allows parties to share returns and mitigate project risks.

Most large firms, including EFIC's clients, regularly utilise those sources of finance (tables 3.5, 3.6 and box 3.6 provide examples).

Table 3.5 **Examples of EFIC's clients' equity raisings**

Client	*Issued or held on or over the year ending*	*Value A$ mil*	*Description*
Leighton Holdings	11/04/2011	740	Rights issue
Orica	30/09/2011	490	Step-up preference shares[a]
Santos	31/12/2011	6 392	Fully paid ordinary shares[b]
Santos	31/12/2010	5 514	Fully paid ordinary shares[b]
Transfield Services	21/01/2011	294[c]	Fully underwritten 2:9 accelerated non-renounceable entitlement offer[c]
WorleyParsons	30/06/2010	51	Ordinary shares issued[b]

[a] Step-up preferences shares were reclassified to debt from 13 October 2011. [b] Issued capital. [c] Before transaction costs.

Sources: Leighton Holdings (2011); Orica (2011); Santos (2011a); Transfield Services (2011); WorleyParsons (2010).

Box 3.6 **Case study — Santos' ability to raise long-term finance**

Santos raised a total of EUR1 billion in subordinated notes for the Gladstone LNG project.

The hybrid securities are due to mature in 2070 and can be redeemed by Santos from the optional redemption date — 22 September 2017.

The securities pay investors a fixed rate of 8.25 per cent semi-annually until the optional redemption date. If securities are not redeemed by Santos, the notes will continue to pay investors 6.85 per cent above the three-month Euro Interbank Offered Rate in quarterly instalments until maturity.

After issuing EUR650 million initially, Santos 'received significant demand from investors for a follow-on issue' (Santos 2010f, p. 1). A media release explained that the 'strong support [Santos] received from offshore and domestic investors demonstrates the strength of the Santos credit' (Santos 2010e, p. 1). The success of the notes issue demonstrated Santos' 'ability to source capital from a diverse range of sources on attractive terms' (Santos 2011c, p. 1).

In addition to the issue of subordinated notes described above, Santos' funding plan for the Gladstone LNG project included an equity raising, an institutional placement, A$2 billion of undrawn bank lines with an average maturity of five years and 'potentially including bond and Export Credit Agency backed finance' (Santos 2010c, p. 13; Santos 2010b, p. 5).

Table 3.6 **Examples of EFIC's clients obtaining debt finance**

Client	*Value ($mil)*	*Maturity (years)*	*Date of issue*	*Description*
Leighton Finance Limited[a]	US$111 US$90 US$79	5 7 10	15/10/2008	Guaranteed senior notes
Leighton Finance Limited[a]	US$600	2	8/12/2010	Syndicated bank facility
Leighton Finance (USA) Pty Limited[a]	US$90 US$145 US$115	5 7 10	21/07/2010	Guaranteed senior notes
Orica Limited	US$335 US$80 US$85 US$100	10 12 15 20	11/08/2010	Guaranteed senior notes
Santos	A$1 450 US$500	2-5[b] 2-5[b]	31/12/2011[c]	Undrawn bilateral bank loan facilities
Transfield Services	US$20 US$50 US$100	5 7 10	30/06/2011	Long-term senior unsecured notes
Transfield Services	A$150 US$100 A$84 US$100 NZ$63 CLP5 634 A$250	1.5 1.5 2.5 2.5 2.5 2.5 3.5	30/06/2011[c]	Unsecured multi-currency debt facility composed of a number of tranches with a syndication of 13 banks, equivalent to A$731 million.
UGL Limited	A$110	5	30/06/2011[c]	Term debt facility
UGL Limited	US$50 US$200[d]	5 7[d]	30/06/2011[c]	Bank loans US Notes
WorleyParsons	US$10 US$22 US$175	5 7 10	03/2011	Unsecured notes
WorleyParsons	US$144	10	04/2011	Unsecured notes
WorleyParsons	US$140 US$169	7 10	05/2007	Unsecured notes

[a] Wholly owned subsidiaries of Leighton Holdings. [b] Facilities mature between 2014 and 2017. [c] Facilities at reporting date. [d] Tranche 2 is for US$150 million maturing June 2018 and Tranche 3 is for US$50 million maturing September 2018.

Sources: Leighton Holdings (2011); Orica Limited (2010b); Santos (2011a); Transfield Services Limited (2011); UGL Limited (2011); WorleyParsons (2011).

Alternatives to insurance

Although the risks of doing business can impose costs on exporters, insurance is not essential for an export transaction to proceed. Only 11 per cent of world trade was insured in 2009 (Mora and Powers 2011). Even if privately provided insurance products are not cost-effective for some exporters, they may have access to alternative risk management and mitigation tools (box 3.7).

Box 3.7 **Examples of alternative risk mitigation strategies**

Exporters may be able to manage and mitigate some of their commercial and political risks without using insurance by:

- negotiating cash in advance payment terms or an irrevocable letter of credit
- researching the creditworthiness of counterparties and foreign laws to make better decisions
- hedging export orders against foreign exchange rate movements
- reducing the proportion of exports sent to a country prone to war
- spreading their dealings across a range of counterparties.

Sources: Austrade (nd); Bank of Queensland (2011).

Firms may also have the option of partially insuring their activities. For example, an exporter can use a flexible forward contract (box 3.4) to partially hedge their currency exposures. The option of operating with no insurance, self-insurance or partial insurance may be efficient for some transactions.

Risk management and mitigation tools have costs and some may be more readily available to large firms. Larger firms have a greater capacity to raise equity, which can be used in instances of default by customers. They also have greater scale to diversify their operations across customers, sectors and countries. Larger firms have greater bargaining power in negotiating terms and conditions, including price.

The option of not proceeding with the transaction

In addition to risk management and mitigation tools, firms have a range of options when developing their business model and planning their capital structure. If a firm is unable to attract finance (debt or equity) or insurance, it may be that the most efficient outcome is for the transaction not to proceed at that time, or with the current business model, because more efficient firms will supply the goods and services, or the resources will go to higher value activities. It may also be possible to attract finance by altering the transaction (discussed further in chapter 7).

3.6 In sum

This chapter has discussed the coverage of trade finance and insurance products and services by private sector providers and EFIC. A direct comparison of coverage is challenging, because it is difficult to ascertain a particular private provider's willingness to supply a product and the terms and conditions, including price, under which it would be offered. Nevertheless, several conclusions can be made:

- Most international trade is undertaken without the support of any financial intermediaries, and most trade finance and insurance is provided by the private sector. Many Australian exporters access international providers of trade finance and insurance services.
- By international standards, Australia has well developed, deep and liquid financial and insurance markets.
- Most of the products offered by EFIC are also available from the private sector.
  - The exception is some types of guarantees, such as the foreign exchange guarantee facility. By design, these products are intended to complement the products offered by the private sector.
- The differences in the coverage of EFIC and private sector providers primarily relate to the terms and conditions, including price, on which EFIC is able to offer its products. There may be commercial reasons why the private sector is not able to match these terms, and at times, it may be more efficient for the transaction not to proceed.
- In addition to private sector finance, exporters have other financing and business options, including raising equity or changing their business plan.

Subsequent chapters discuss whether the differences between EFIC and the private sector's coverage justify government intervention.

FINDING 3.1

Most products offered by EFIC are also offered by the private sector, although the price and other conditions of provision may differ.

4 Analytical framework

Key points

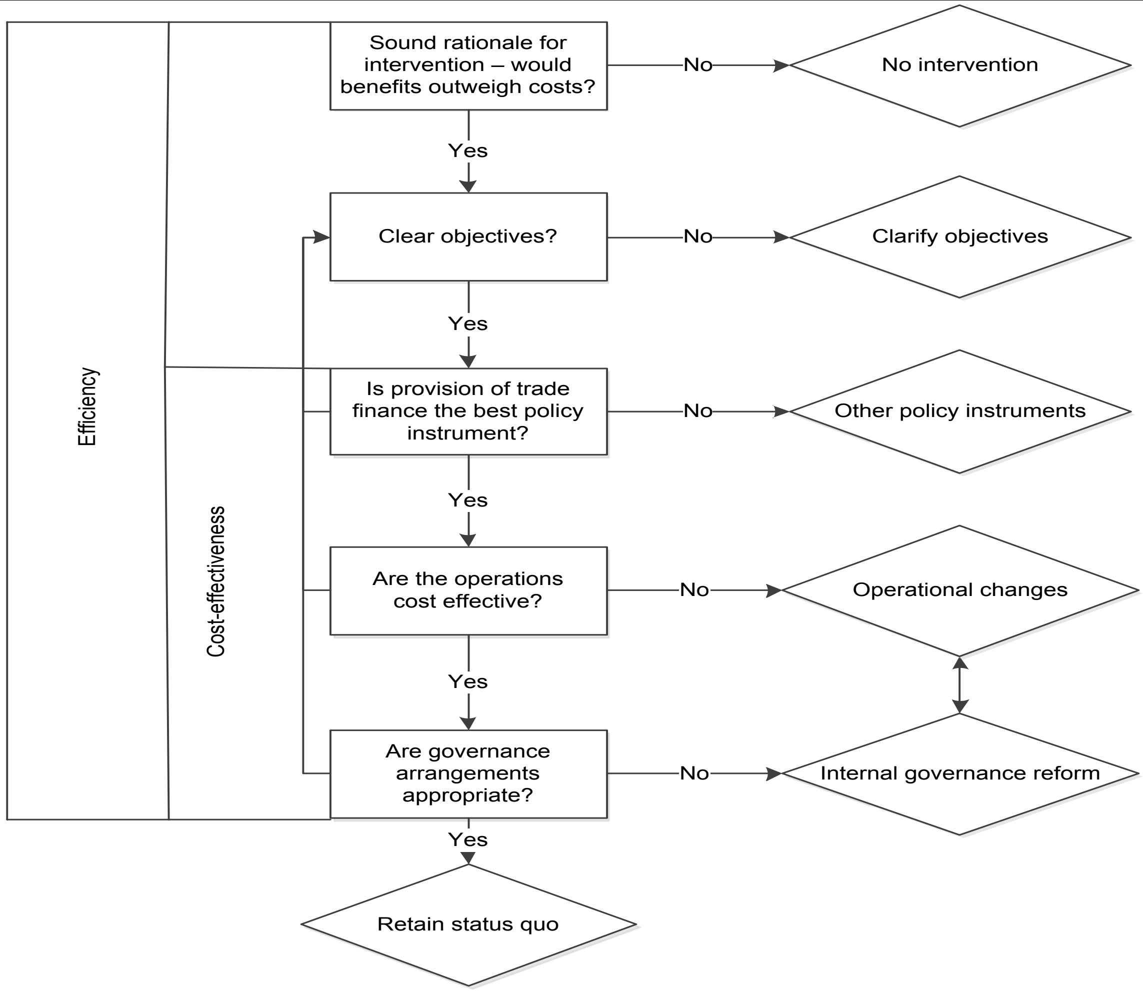
- An assessment of the efficiency of Australia's export credit arrangements involves examining the rationale for government intervention, identifying the most appropriate form of intervention, and evaluating whether EFIC's activities and governance arrangements efficiently implement that intervention.
- Government intervention in export credit and insurance markets is only warranted if it addresses a market failure in a way that generates a net benefit to the Australian community.
  - Market failure occurs where transactions that would enhance economy-wide wellbeing are not proceeding. The fact that some transactions (or projects) are unable to attract private sector support is not a market failure and may reflect assessments by market participants of the expected return of the transaction.
  - Even where a market fails, the case for government intervention rests on whether the economy-wide benefits outweigh the costs.
  - In the absence of a market failure, government intervention would direct support to projects or transactions that were refused by private sector providers on valid commercial grounds. Intervention in the absence of market failure distorts market signals and the allocation of resources in the economy.
- There is a risk of policy failure when governments intervene in financial markets by providing finance to projects rejected by the private sector.
  - In Australia, previous government attempts to provide finance to projects that have struggled to attract commercial interest have ended in commercial failure and imposed substantial costs on the taxpayer.
  - In general, Australian Governments have moved away from owning financial institutions to pursuing competitive and stable financial markets governed by a robust prudential structure.
- Appropriate governance arrangements are essential to minimise the likelihood of policy failure and the risks to the taxpayer, as well as the reputational risks to the government.
- The distribution of the costs and benefits of Australia's export credit arrangements is important both for equity and efficiency reasons.
  - Some of the benefits of government support may accrue to businesses and individuals outside of Australia, especially the buyers of exports.
  - There are equity and efficiency considerations arising from some firms receiving government support, while others do not, especially when assistance flows to less efficient firms.

This chapter outlines a conceptual framework for economic analysis of Australia's export credit arrangements. This framework will be applied in assessing existing arrangements, as well as potential options for reform.

4.1 What are the policy design questions?

An assessment of Australia's export credit arrangements can be conceptualised as a hierarchy of interdependent policy design questions. The issues that need to be resolved range from the high-level questions of ensuring that the policy objectives are clear and that there is rationale for government intervention, to identifying specific areas of reform (figure 4.1).

Figure 4.1 **Mapping the policy questions**



The remainder of the chapter presents an overview of the issues relevant to the above policy questions. Subsequent chapters consider those issues in greater detail.

4.2 Rationale for intervention

Objectives

Clearly defining the policy problem is a fundamental step in the design of a new policy, or the assessment of an existing one.

At a high level, there are two requirements that could apply to most policy objectives. First, they should be consistent with the goal of enhancing economy-wide welfare. This requires an understanding and recognition of the underlying policy problem in a broader context. For example, policies that focus exclusively on promoting the interests of a particular section of the community, say exporters, could overlook potential negative effects in other parts of the economy and run the risk of reducing the welfare of the community as a whole.

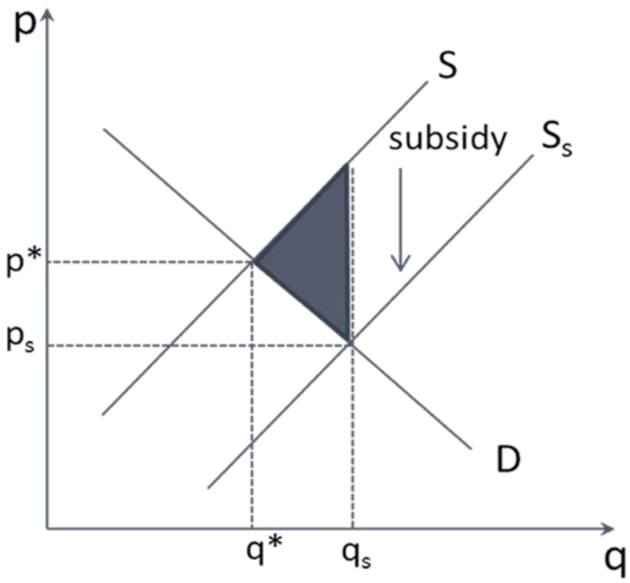
Second, the objectives need to be sufficiently specific to allow adequate targeting, and subsequent evaluation of the policy, but not be too prescriptive to unduly restrict the range of options to address the problem (Australian Government 2010).

Market failure

Australia's export credit arrangements could generate both benefits and costs to the economy. However, government intervention is only warranted when the benefits outweigh the costs. Generally, when markets — including financial markets — function well, they promote efficiency by allocating resources to their highest valued uses. In those cases, government intervention to alter consumption or production (for example, by way of a subsidy) will lead to a net loss for society (box 4.1). Although policies of this nature benefit those that receive assistance, the costs borne by the rest of the community outweigh those benefits.

Box 4.1 The effect of subsidising production in efficient markets

The demand and supply of a product are stylised below. The quantity of the product consumed and produced is measured on the horizontal axis, the value of the benefits and costs of the product on the vertical axis. The S curve represents the incremental costs of supplying additional units of the product. Its upward slope reflects the scarcity of the resources required to make the product — as resources become more scarce, the cost of each new unit produced will rise. The D curve represents the demand for the product. Its downward slope reflects that the incremental benefits of consuming more of a particular product decline as this product becomes more abundant (relative to other products that consumers may wish to consume). The intersection of the two curves shows where the incremental costs of production to society equal the marginal benefits of consumption and the optimal price and level of consumption and production are p* and q*.



The government could try to increase the production and consumption of a product by subsidising its supply. This would increase the supply to a new curve S_s and lead to a lower equilibrium buyer price p_s and higher level of production and consumption q_s. The subsidy would impose a cost on taxpayers. Some of this cost would be offset by the gains to the beneficiaries of the subsidy — the producers and consumers of the product. However, some of the costs of the subsidy will not be matched by the benefits. This is because the subsidy leads to a level of supply at which the additional costs of production to society have begun to exceed the benefits of consumption. The shaded triangle reflects the aggregate loss to society from increasing consumption and production beyond the socially optimal level.

Few, if any, markets conform to the competitive ideal and market failures arise for several reasons (box 4.2). Despite this, most markets operate in a way that enhances community welfare and do not require government intervention. Even when government intervention appears to be necessary it is important for policy makers to note that government intervention is never perfect and the cost of interventions will generally need to be weighed against their benefits.

Box 4.2 **Five sources of 'market failure'**

Externalities arise when the actions of an individual or firm create a benefit or a cost for others who are not a party to the transaction and these impacts are not reflected in market prices.

Public goods arise where consumption of a good is non-rivalrous (consumption by one person does not affect the amount available to others) and non-excludable (people cannot be prevented from consuming the good). Producers and consumers cannot capture the full benefits of provision and payments for provision cannot be enforced. Consequently, public goods are likely to be under-provided by the private sector.

Inadequate information about a transaction can occur where there are institutional or cost barriers preventing parties to a transaction obtaining relevant information about the characteristics of a transaction (most notably risks) and/or each other. In such cases, market participants may adopt simplified decision rules based on a reduced set of information.

Information asymmetry arises where one of the parties knows more about key aspects of the transaction than the other. One possible consequence is 'adverse selection' — a bias toward entering into lower quality or higher risk transactions. Another potential problem is 'moral hazard', which occurs when a party modifies its behaviour after the transaction to exploit any information advantage.

Lack of effective competition may arise in the presence of market characteristics such as natural monopoly or when the market has a small number of firms that are able to restrict output and maintain prices above optimal levels. A small number of participants in the market alone is not evidence of the exercise of market power. The threat of new entrants may discourage the use of market power.

Failures in financial markets

Market failures in financial markets may manifest in the availability of debt or equity being restricted in the economy as a whole, or in segments of the market. They may also result in 'irrational exuberance' in financial markets where there is an excess supply of credit or it is supplied at a below optimal price — also an inefficient outcome. The OECD noted:

> When market failures exist, financial markets may not efficiently manage financial risk, may not allocate resources across space and time optimally, and may be subject to other weaknesses. (2008a, p. 6)

In the past, governments have sometimes intervened to correct perceived financial market failures by providing finance for what they saw as commercially viable projects rejected by the private sector. However, governments are not necessarily as well placed as the private sector in assessing and pricing risk or allocating credit. They are not subject to the same level of scrutiny as private sector providers that have to account to their shareholders for their decisions. Nor do they face the same consequences as the private sector from poor judgements.

Although the following is not an EFIC transaction, it does illustrate that governments can and do lose from providing loans and guarantees to promising opportunities (opportunities the private sector had rejected). Following the launch of the Stanwell magnesium project in March 2000, the Australian and Queensland Governments gave considerable support in the form of grants and loan guarantees (Lipton, Steinberger, and Ketcher 2003). The Australian Government was very confident about the project (Minchin 2001). However, despite this support, the Australian Magnesium Corporation faced difficulties with the Stanwell project leading to its termination in June 2003. The collapse of the project resulted in significant costs being transferred to the taxpayer.

Government run financial organisations have similarly had mixed success in allocating credit to viable projects. Although some have been successful, others such as the Victorian Economic Development Corporation, the West Australian Development Corporation, and the state banks of Victoria and South Australia failed at substantial cost to taxpayers and the economy as a whole.

Why can't some transactions attract market interest?

Even in well-functioning and competitive financial markets some transactions will not proceed.

At any one time market participants will compare the costs and opportunities of a variety of transactions. If some transactions cannot attract market interest at any price or only at a very high price this could simply reflect commercial decisions about allocating scarce resources given relative costs, benefits and risks. In this context, there will always be gaps between demand and supply. Unconstrained by price, society's demand for any product will typically exceed its capacity to meet it and, similarly, not every proposal will find a financier or insurer. It is not a market failure unless it is a situation where the market fails to deliver an outcome that would improve community wellbeing at the *economy-wide level*.

Transactions that do not attract commercial interest could stem from either a market failure, or because the underlying commercial aspects of the transaction mean that market participants prefer instead to invest in projects elsewhere that generate greater expected returns. Government intervention in the latter case diverts resources from more commercially attractive projects and runs the risk of policy failure — similar to that encountered by the Stanwell magnesium project discussed above.

FINDING 4.1

There can be sound commercial reasons why private sector providers do not offer some products or are unwilling to provide them to some exporters or buyers. Such cases are not market failures.

When should government intervene?

The key policy question is whether government intervention will generate a net benefit to the community. The test of whether government should intervene is not whether there is a gap between what is supplied and demanded (because there will always be gaps), but rather do the benefits for the economy of the intervention exceed the costs.

The relevant considerations for policy are:

- the nature and impact of the market failure and the extent to which it can be corrected through intervention. Evaluation of this involves identifying the relevant economic counterfactual against which the intervention is to be assessed. From a policy perspective, the question is not whether the transaction or project would proceed or not, but rather what is the cost at the economy-wide level of leaving the decision to the market participants and what is the capacity of the government to improve on market outcomes
- the likely costs of government intervention, including:
  - the opportunity cost of the resources used to assist the provision and consumption of export finance and insurance, including the costs to government of raising the required funds through taxation, and any broader economic, environmental or social impacts of the policy
  - the administrative costs for the government and the compliance costs for businesses and individuals.

A further qualifier on the rationale for, and form of, government intervention in financial markets is the fact that specific market failures are often not permanent and could change over time. Thus, even if the rationale for intervention existed when government first intervened, it is important to regularly assess the case for continuing government involvement. Furthermore, where the market failure is likely to be of a very short-term nature, government involvement may not be warranted in the first place.

Other rationales for intervention

Government provision of export assistance generally, and export finance and insurance specifically, is sometimes advocated for reasons other than market failure. For example, some advocates for general export enhancement argue that it could achieve strategic trade objectives or macroeconomic objectives, such as improvements in the balance of payments, or increased employment. Several participants (for example, AMWU, sub. DR111; CFMEU, sub. 10; Incat, sub. DR56) noted that EFIC's assistance could help overcome challenges faced by Australian exporters, such as the high Australian dollar. Sometimes the argument for intervention is simply that the government has natural advantages over the private sector in scale, ability to spread and manage risk, expertise and access to information.

The Commission assesses the merits of a range of potential rationales for government intervention, including those discussed above in chapter 5. Where no market failure is found, the Commission's approach is to conclude that there is no economic rationale for government intervention — that is, the economy-wide benefits of intervening on those grounds are likely to be exceeded by the costs. This is not to say that there are no private benefits accruing to participants involved in the intervention but rather that those benefits come at a cost to others either as a result of distortions, subsidies or inappropriately priced transfers of risk.

4.3 Achieving cost-effectiveness

Provided the in-principle rationale for government intervention is established, the next step involves maximising its cost-effectiveness, that is, achieving the objectives at the lowest possible cost.

At the outset, this requires answering the question of whether provision of export finance and insurance is the most direct and effective way of addressing any market or government failures. In large part, the answer depends on how directly the instrument targets the policy problem. Beyond that, the issue is whether and how the current arrangements for providing export finance and insurance can be improved.

Targeting the market failure at its source

Policies that target a market failure directly at its source can confer several advantages. First, it reduces uncertainty about the causal linkages between the policy and the intended outcome, and improves the effectiveness of the policy (PC 2010c). Second, the costs to the taxpayer will be lower if the scope of government intervention is confined solely to the policy problem. Third, to the extent that such targeting of the policy problem facilitates subsequent market solutions, it would capitalise on the advantages that markets have over governments in allocating resources to highest-value uses. For example, if there is incomplete information about the political risks of exporting to a particular country, providing the missing information to market participants may be a more effective and less costly response than direct provision of export finance and insurance. Similarly, if changes to financial market regulation impose an inefficient constraint on the availability of debt or equity to a particular exporting sector, the appropriate response is more likely to be found in regulatory reform or sector-wide policies than through government involvement in individual transactions.

This is not to say that direct targeting of the market or policy failure will always be feasible or successful. There may be institutional constraints or implementation difficulties that make this approach impractical. It is important to consider whether other policy instruments could address the problem more effectively or at a lower cost.

Targeting financial market failures — some past experiences

Past government responses to perceived financial market failures have varied, ranging from broader policies, such as monetary policy and government ownership of financial institutions, to more targeted responses such as regulation of the financial sector and various incentive mechanisms (box 4.3).

Over the past 30 years, and following two broad inquiries into Australia's financial system, there has been a general recognition that targeted approaches to addressing any market failures are preferable. There has been a clear trend away from the potentially risky approach of government ownership of financial institutions, prompted by the high-profile collapses of government-owned banks such as the State Bank of South Australia and the State Bank of Victoria (Armstrong and Gross 1995; MacPherson 1993).

Box 4.3 **Government responses to financial market inefficiencies**

Australian Governments have used a variety of policies to address perceived inefficiencies in financial markets, including:

- government ownership of financial institutions — in the period up to the mid-1990s government-owned financial institutions were widespread. The Australian Government owned the Commonwealth Bank of Australia and there was a state government-owned bank in every state. The 1990s saw a broad trend of privatisation, in some cases prompted by the financial mismanagement and/or collapse of these institutions
- regulation — prior to the mid-1980s financial institutions were subject to extensive and prescriptive regulation which greatly constrained both the number of providers (for example, foreign banks could not operate in Australia) and the day-to-day operation of existing market participants (including through lending rate controls, limits on what financial products could be offered, and controls on deposit amounts and terms). These regulations reflected macroeconomic, equity and efficiency concerns. Following the *Australian Financial System Inquiry* in 1981, the Australian Government commenced a process of deregulation, which relaxed many of those constraints. The reform continued with the 1996-97 *Financial System Inquiry* undertaken by the Wallis Committee. The conclusions of that inquiry focused on achieving competitive financial markets governed by a robust prudential structure
- incentive mechanisms for consumers of financial products — the policies adopted at various stages included, for example: subsidised loans (such as the Green Loans scheme, discontinued in 2010); the current tax concessions to venture capital markets; and different forms of assistance to help small and medium-sized enterprises become market ready.

Sources: ABA (2004); ATO (2009); Wallis et al. (1997); DEWHA (2010); Macfarlane (1998).

International research also suggests that government-owned financial institutions generally fail to enhance economic efficiency. For example, La Porta et al. (2002) assessed the effects of government ownership of financial institutions in 92 countries, including Australia. They made several findings including that government ownership of banks is:

- particularly significant in countries with low levels of per capita income, underdeveloped financial systems, interventionist and inefficient governments, and those with poor protection of property rights
- associated with slower subsequent financial development
- associated with lower subsequent growth of per capita income and with lower growth in productivity.

The authors concluded:

> … the results are consistent with the political view of government ownership of firms, including banks, according to which such ownership politicises the resource allocation process and reduces efficiency. (La Porta et al. 2002, p. 290)

Similarly, Inter-American Development Bank researchers (Galindo and Mico 2003) looked at the effect of government ownership of banks on growth of manufacturing sectors in need of credit in 34 countries. They found:

> Our empirical evidence suggests that state-owned banks do not promote the growth rates of manufacturing industries that rely on external sources of funding for their operation, nor do they promote the growth rates of manufacturing industries that, due to reduced access to collateral, face tighter financial constraints. On the contrary, the development of a private banking industry appears to have a significant effect on such types of industries. (p. 10)

The OECD (2008a) observed that the focus for governments should be:

- establishing the pre-requisites for the operation of the financial system, including:
  - sound fiscal and macroeconomic policies and monetary controls
  - well-developed infrastructure for financial services, including reliable accounting, auditing, legal and judicial, and tax systems
- targeting market failures at the source through either incentive mechanisms, competition policy, financial education, or regulation.

Reducing the opportunity costs

Opportunity costs of capital

The capital used by an export credit agency (ECA) to provide its products and services (including any contingent liabilities of the government) has an opportunity cost. Opportunity cost reflects the value of the best alternative use of that capital. If there is a higher return from investing those funds elsewhere — either through government programs or by private businesses and individuals, the ECA would be distorting the allocation of resources (discussed below) and generating a net cost to the economy.

Distortions in export finance and insurance markets and the broader economy

Government provision of export finance and insurance can affect the incentives and behaviour of both providers and consumers of these products.

On the supply side, ECAs may crowd out private sector provision of export finance and insurance for commercially viable transactions if there is direct competition with existing providers, or if government provision creates a barrier to entry for other businesses. ECAs may also attract private sector provision of export finance and insurance beyond optimal levels through co-operative arrangements that effectively subsidise private providers or consumers of the supported exports.

Distortions may also arise on the demand side of export finance and insurance markets. If exporters perceive a benefit from receiving these products from the government, rather than seeking alternative sources of funding or insurance, such as equity finance, they may engage in strategic behaviour to secure or retain this benefit.

Government provision of export finance and insurance can also have broader effects across the economy, unless it is done on the basis of market failure and the benefits outweigh the costs. If government provision assists particular industries, resources would be artificially shifted to those industries at the cost of other sectors. It may be the case that by supporting a transaction an ECA is conferring a benefit on a business less efficient than one that would have undertaken the activity but for the ECA's support. The various channels through which distortions could arise are examined further in chapter 7.

The size of the distortion is determined predominantly by how an ECA prices its products and the characteristics of the affected markets. In general, distortions are less likely to occur if the ECA faces the same incentives as the private sector to price its products and services efficiently. If there are price differentials, the key factor determining the magnitude of any misallocation of resources is the sensitivity of the market participants to price changes. For example, if the demand for export finance is highly sensitive to price, providing the product at a subsidised price would lead to a greater increase in consumption and a bigger distortion than if demand varied little in response to price changes.

One way of assessing whether EFIC is likely to create distortions is by examining how EFIC selects and prices the transactions and how it prices risk. Another approach involves looking at the financial performance of EFIC's operation after accounting for any commercial advantages it may have by virtue of its exemption from competitive neutrality arrangements. This is covered in chapters 6 and 8.

Appropriate governance arrangements

Ensuring that the governance structures responsible for policy development, implementation and oversight are effective is fundamental to the success of any policy. At a high level, this requires that:

- the responsibility for components of the policy task is allocated to agencies best equipped to deliver them, taking into account the relevant skills, expertise and administrative costs, as well as potential conflicts of interest
- adequate arrangements are in place to ensure accountability (PC 2010c).

The risks from inadequate governance arrangements can be considerable for the taxpayer and the reputation of the government.

Chapter 9 sets out the principles of good governance in greater detail and adopts them to assess the case for governance reform of EFIC.

4.4 Distributional effects

Distribution of the benefits between exporters and importers

EFIC's provision of a facility to an importer or exporter does not necessarily represent who will be the beneficiaries. The benefits may ultimately be shared by both the exporter and the importer, and partner private sector financial institutions (who would be able to increase their involvement, while achieving better conditions and transferring risk). The distribution of the benefits from assistance depends on the demand and supply characteristics in the relevant markets, and the magnitude of any change in prices.

At a broad level, the following factors determine the ultimate distribution of the benefits:

- the responsiveness of the demand for imports to changes in the price — if the world demand for a particular product is not sensitive to price, subsidising the supply of that product will simply reduce its price in world markets rather than increase the quantity consumed. Thus, the subsidy to exporters would end up primarily benefiting the consumers in the importing country
- the responsiveness of the assisted exporter to changes in the price — the greater the increase in the export volume in response to the assistance from EFIC, the greater the likely fall in the price paid by the consumers in other countries, and the greater the benefit that will accrue to them

- the ability of the assisted exporter to change the world price by increasing its export volumes — if the increase in the export volume is large it will confer greater benefits on consumers in other countries through lower prices. If, on the other hand, the exporter cannot influence the world price, it will gain the entire benefit of the subsidy, albeit at a net cost to the economy, as more resources are shifted to export production than would have occurred in the absence of the subsidy (Fitzgerald and Monson 1989; Fleisig and Hill 1984).

Even where exporting firms can benefit from EFIC's assistance, this does not necessarily imply that all of the benefits received by exporters accrue to the exporting country. There will be a leakage of benefits overseas in circumstances where the parties to an export transaction supported by EFIC are foreign-owned.

Distributional consequences within Australia — efficiency and equity

EFIC's activities in markets also have implications for the manner in which resources are distributed between various persons and entities within the Australian economy. The distribution of the benefits of Australia's export credit arrangements is relevant from an equity and an efficiency perspective.

Efficiency consequences

Some may argue that the goals of EFIC would still be achieved even if a foreign-owned company is assisted and if prices for the exported good or service were falling, because exports would have increased and employment in that part of the economy would have increased as result. However, that is only part of the picture. If those resources would have been more efficiently employed elsewhere in the economy then there would be a net efficiency loss. EFIC's private sector partners may still be beneficiaries and the importer and exporter may still consider they gained, but in the absence of a market failure these gains will be outweighed by the costs. There would be a reduction in community welfare, particularly in circumstances where the economy is close to full employment.[1]

Equity consequences

To the extent that one of the objectives of government policy is an equitable distribution of the costs and benefits in the community, the winners and the losers

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[1] If the economy is operating at or close to full employment, government stimulus applied to one area will simply draw resources from other areas with little net impact on aggregate output.

and the magnitude of their gains and losses need to be identified (Australian Government 2010).

In some instances, (and where a market failure rationale for intervention is not established) the benefit gained by an assisted exporter could come at the expense of domestic competitor companies who do not receive assistance. Downer EDI Limited (sub. DR40, p. 3) observed that ECA finance gave it a 'competitive advantage when Downer is bidding on tenders in the knowledge it has access to the prerequisite funding'. The Commission has come across cases where EFIC's assistance to one domestic producer gave it an advantage over other domestic producers (discussed in chapter 7).

There may also be cases where EFIC's assistance is directed to firms that do not need it, because those firms can access alternative sources of finance and insurance, albeit at a higher price. Considerations of the efficiency of this outcome aside, the fairness of conferring a benefit on those firms at the expense of the general taxpayer is another important consideration.

A note on the Commission's methodology

In its assessment of the likely impacts of current and proposed arrangements, the Commission has not sought to quantify the costs and benefits for the Australian economy. Some participants, (for example, EFIC, sub. DR90; Malcolm Stephens, sub. DR93) criticised this approach.

In the context of the issues the Commission considered in this report, a quantitative analysis is not required to determine whether the proposed arrangements would deliver a net benefit to the community. If the current arrangements fail the threshold test of being based on a sound rationale for government intervention, the outcome would be a net loss for the Australian economy.

Further, an economy-wide modelling exercise is required to accurately measure the costs and benefits and associated flow-on effects of current and proposed arrangements. Given the small size of EFIC relative to that of the Australian economy, any estimates would be extremely sensitive to assumptions, difficult to discern from model 'noise' and, ultimately, highly unreliable.

5 Economics of export finance and insurance

Key points

- Potential rationales for government intervention in export finance and insurance markets have been raised in some of the literature and by participants to this inquiry. These include: meeting broader national interest objectives; arguments for export support to generate multiplier effects in the economy; and addressing perceived problems in financial markets.
- Government intervention to promote exports will only be warranted where it addresses a market failure in a manner that generates a net benefit to the economy.
- Government intervention in export finance markets should be targeted at failures in those markets that impede otherwise commercially viable export transactions.
- There may be some instances of market failure that may warrant government provision of export finance through EFIC. These potential market failures are information-related and limited to:
  - problems arising from private sector providers adopting simplified decision rules to lower transaction costs
  - temporarily missing markets arising from a severe disruption in financial markets in particular countries.
- These potential information-related failures are likely to be limited to newly exporting small and medium-sized enterprises (SMEs) — those SMEs with limited export experience or SMEs attempting to access emerging export markets — that are seeking export finance.
- Until it is next reviewed, EFIC's commercial account objective should be to efficiently address the information-related failures in financial markets that affect newly exporting SMEs. EFIC's role should be to demonstrate to the private sector that providing export finance to these exporters can be commercially viable.
- In cases where there is a temporary disruption in an export market, EFIC has a potential role in reinsuring risk. Any such assistance should be priced on commercial terms, limited to reinsurance, available for a defined period and include an exit plan.
- In some cases, it may be appropriate that governments use export credit agencies to meet national interest objectives.

This chapter considers potential rationales for government intervention in export finance and insurance markets, a number of which have been raised in some of the literature and by participants to this inquiry. These include: meeting broader national interest objectives; arguments for export support to generate multiplier effects in the economy; and addressing perceived problems in financial markets.

5.1 National interest rationales

On occasion, governments use export credit agencies (ECAs) to support projects or transactions identified as being in the national interest. National interest considerations are separate from the rationales used to justify government intervention in export finance and insurance markets, and may include governments lending to foreign nations to achieve foreign policy outcomes. In other cases, governments have justified ECA support on the basis that protecting and encouraging defence-related industries is in the national interest (Fleisig and Hill 1984). EFIC also noted that Japan and Korea are investing in Australia through their ECAs to meet long-term resource security objectives by contracting purchases in advance (trans., p. 160).

As discussed in chapter 2, the Export Finance and Insurance Corporation (EFIC) administers a dedicated national interest account on behalf of the Australian Government. Through this account, the Australian Government is able to support transactions that it deems are in the national interest. For example, the Australian Government provided Indonesia with a $500 million concessional loan in the wake of the 2004 Boxing Day tsunami (JSCFAT 2006). In another instance, the Australian Government granted a US$250 million loan on the national interest account to a liquefied natural gas project in Papua New Guinea (EFIC 2010a). The (then) Minister for Trade remarked:

> This project will provide a boost to PNG, the region, and Australia … Beyond Australia's competitive advantage and expertise in this field, the PNG development could enhance the significance of our region as a global supplier of energy … the Australian Government, with the PNG Government, is focused on ensuring that the project lives up to its potential, and benefits all regions and people of PNG. (Crean 2009b)

Proposed changes to governance arrangements for the national interest account are discussed in chapter 9.

5.2 Broader rationales suggested for export support

There are many other suggested rationales for providing government assistance to exporters through intervention in financial markets. This section examines their merits.

Supporting exports as an end goal

EFIC was established to encourage Australian export trade through the provision of insurance and financial services and products. Some submissions have argued that the promotion of exports as an end goal is desirable:

> All companies should have access to whatever mechanisms are available to help gain an export, be it through EFIC or otherwise. Exports and exporters must be encouraged and assisted by whatever means possible. Surely that is in the best interests of the country! (Incat Australia, sub. DR56, p. 2)

In addition EFIC has also pointed to research that suggests exports are inherently deserving of government support. It cited Hufbauer (2001) of the Peterson Institute of International Economics who claimed that exports were special:

> Ex-Im could have been safely retired at age 65 if there was nothing special about exports. But there is something special. (Hufbauer 2001)

In the US context, Hufbauer goes on to claim that exports have been a major source of economic growth, and that the US government should promote exports through the US Export-Import Bank (Ex-Im Bank).

The Commission does not support this position. In order for government intervention to increase exports *and* generate net benefits to the economy, that intervention must efficiently target market failures that are impeding otherwise commercially viable export transactions. Promoting exports *per se* will generally only shift domestic resources (labour and capital) away from more profitable activities and potentially drive down prices of the exports (benefiting foreign buyers) and reduce, rather than increase, Australia's aggregate income.

As the Chairman of the Commission has previously noted:

> … the production, marketing, and delivery of goods and services for export all employ resources and thus have opportunity costs. For Australia to gain from any particular exporting activity, the benefit received needs to exceed the value that could have obtained by using the embodied resources to supply the domestic market. Hence, it cannot be presumed that additions to exports, particularly if induced artificially by assistance, will yield a net payoff to the community. (Banks 2008, p. 11)

Increasing GDP and domestic employment

The former Deputy General Counsel of the US Ex-Im Bank stated:

> Export transactions supported by Eximbank have immediate salutary effects on the domestic economy. Employment is increased, real income is created, and capital is effectively put to use in developing the country's resources. (Rendell 1976, p. 112)

This view was also expressed to the Commission during the course of this inquiry. For example, Lean Field Developments noted:

> Australia must export if it wishes to reduce unemployment, diversify domestic industry and increase productivity. (sub. DR78, p. 4)

Similar sentiments were expressed by other participants including Incat Australia (sub. DR56) and Investec (sub. DR72), and by some authors (Tschetter 2008).

Although efforts to promote exports may be successful at increasing production in export industries, in economies that are at or close to full employment, it is not necessarily the case that national income and employment will rise as a result. Abstracting from terms of trade changes and increases in the quantity of resources (including labour) available for production, promoting export activity in a fully employed economy will draw labour and other resources away from other, non-exporting activities, leading to lower production in those areas (Banks 2011; Fleisig and Hill 1984). At best, such an approach is likely to have no discernible effect on the number of jobs in the economy:

> … promoting exports through subsidised financing or through government-backed insurance guarantees will not permanently raise the level of employment in the economy, but alters the composition of employment among the various sectors of the economy and, therefore performs poorly as a jobs creation mechanism. (Ilias 2011, p. 13)

Even in situations with less than full employment of resources, an artificial shift in resources to the export sector (through government subsidies) will come at a cost to other sectors of the economy.

Balance of payments considerations

Policies intended to promote exports have sometimes been justified on the grounds that they improve a country's balance of payments position (Gianturco 2001).

Broadly speaking, the balance of payments consists of two main accounts: the current account, and the capital and financial account. The current account includes transactions for the purchase and sale of goods and services overseas, as well as income received from, and paid to, overseas residents. The capital and financial account primarily measures financial transactions arising from investment activity. All of the transactions measured in Australia's balance of payments accounts involve trading in Australian dollars and foreign exchange.

The argument for export promotion on the grounds that it leads to a balance of payments 'improvement' has little relevance in economies with a floating exchange rate. This is because any change in exports arising from export assistance will result in a movement in the exchange rate to return the balance of payments to zero. Artificially increasing exports to boost the exchange rate will come at a cost to other exporters and domestic producers as their competitiveness will have been reduced.

Imperfect competition and strategic trade theory

There is a well-established base of economic literature on strategic trade theory suggesting that, under certain circumstances, a domestic government can use subsidies (for example, through its ECA) to advantage its own economy at the expense of an overseas competitor (for example, Spencer and Brander 1983; Brander and Spencer 1985; Krugman 1984). This economic literature does not necessarily lead to the conclusion that strategic trade theory is a sound rationale for government intervention to promote exports.

First, a positive outcome is only possible under specific, restrictive assumptions. The literature generally assumes imperfect competition in the competitor nation. Under this theory, if an Australian and a foreign firm in an oligopolistic market compete for market share in a third country, a subsidy may allow the Australian firm to capture a larger market share in the third country. Furthermore, the gain is only possible if the competitor nation does not retaliate. If both countries subsidise exports it will lead to an outcome where both nations would be better off not having the export subsidy.

Second, achieving a net benefit to the community in practice is unlikely. The informational costs to government of selecting the appropriate level and focus for its support are high as is the potential for policy error. On the other hand, these arrangements come at a cost to all other Australian exporters, consumers and other producers, through the taxes that must be imposed to fund the assistance (or a reduction in public sector spending elsewhere in the economy). This distorts market outcomes in favour of Australian exporters receiving government assistance, potentially reducing the competitiveness of Australian firms not receiving government assistance.

The Commission has previously noted in its report on Australia's Anti-dumping and Countervailing System:

> As several of those outlining an 'in principle' case for strategic trade interventions have acknowledged, the circumstances in which there could in practice be a benefit are very limited, especially when the costs imposed on 'non-strategic' industries are taken into account. (PC 2009, p. 193)

Third, as in the case of supporting infant industries, it may be politically difficult to wind back such support once it is established, and there may be pressure to increase or widen its scope by those who benefit. The Commission has seen evidence of this behaviour during the course of this inquiry from EFIC's clients and various financial institutions.

A drawback of such export promotion policies is that, even if successful, gains to exporters in one country come at the expense of losses imposed on producers elsewhere. This could lead to a situation where subsidised exports from developed countries compete against exports from developing countries.

The final drawback, if such a policy could be implemented successfully, would be an adverse effect on domestic producers, including Australian exporters, through a reduction in their competiveness as a result of a higher Australian dollar.

Alleviating cost and competition pressures

Several participants have argued that the provision of export finance and insurance can help alleviate cost and competition pressures. For example:

> Australian exporters are faced with unprecedented strength in the Australian dollar, high labour costs (particularly affecting manufacturing industries) and severely curtailed finance availability for potential overseas customers. (Austal, sub. DR110, p. 16)

> [Manufacturers] are seeking to develop their export business … They are doing so against a very difficult set of circumstances including the high Australian dollar fuelled by the resources boom, global supply chains extracting the cost savings of mass production by cheap and exploited labour, trade barriers and other inequalities in the global environment. (Australian Manufacturers Workers Union, sub. DR111, p. 1)

All businesses must deal with fluctuations in the price of inputs and changes in relative prices that may advantage their competitors. However, this does not suggest that government intervention is warranted on efficiency or equity grounds. Government intervention to alleviate the pressures felt by exporters would benefit those receiving the assistance, however the cost of doing so is borne by others in the economy. Furthermore, the distortionary effects of transfers of this type, result in resources being used in lower value activities and a loss to the broader economy.

In addition, firms have various mechanisms for dealing with the price changes that affect their industry. For example, those that are exposed to foreign exchange fluctuations have a number of options available to hedge against movements in that price (chapter 3). In some cases, firms may be able to enter into long-term contracts with suppliers to set a price in advance to mitigate these risks. They will also substitute between inputs or alter their production processes to reflect the prices they face. Government is unlikely to have the knowledge required to assist in those strategies.

Some participants noted that the manufacturing sector in particular faced challenges that EFIC may be able to help overcome (see, for example, CFMEU, sub. 10; GP Graders, sub. DR35; Mono Pumps (Australia) Pty Ltd, sub. DR54). As the Chairman of the Commission noted:

> … relative to other industries, manufacturing already gets a lot of government assistance. Net tariff assistance alone was estimated to be around some $6.5 billion in 2009-10, with another $2 billion or so in various subsidies. Rather than providing more assistance, our current fiscal settings suggest that the bigger priority is to determine what this assistance is achieving for the country and whether it could be better spent. (Banks 2011, p.12)

Assistance to one sector, in the absence of a market failure, ultimately comes at a cost to other sectors in the economy.

Correcting externalities

It has been claimed that certain types of exporting activity create positive externalities and the amount of exporting activity will be lower than is optimal without public sector support (Medina-Smith 2001). Two potential sources of externalities can be identified: research and development; and creation of new export markets.

New technology and research and development

A particular exporting activity may involve the development of a new kind of technology from which other firms not party to the transaction may benefit (spillover benefits). It may also result in research and development that has wide applications, and can benefit other firms not directly undertaking the research activity.

Quickstep argued:

> SMEs are the core of innovation in Australia as well as worldwide. It is where most ground breaking technologies are being invented and developed. The domestic Australian market is very small and in our globalised economy, it is essential for SMEs to be able to export to be successful. (sub. DR41, p. 1)

Although positive externalities from technology development may provide a rationale for some form of government intervention, it is unlikely that intervention through the export finance and insurance market will be efficient (Tybout 1999). For example, if production leads to innovations that will provide wider benefits not captured by the producing firm, it would be more efficient to directly subsidise the source of the externality — the production of the good or service — particularly as it makes no difference whether the good or service is exported or consumed domestically.

Creating new export markets

Positive spillovers may arise from 'pioneer' exporting firms that are the first to export to a particular market. For example, a firm that is the first to break into a particular overseas market could establish a good reputation for other exports from the country of origin. Wellard gave one such example, stating:

> [Because of EFIC support] we are now in the process of delivering a turnkey dairy project to the Sri Lankan government that will have every chance of opening a much larger and longer term market for Australian livestock producers and equipment manufacturers. (sub. DR34, p. 1)

However, it is doubtful that government provision of export finance and insurance on such grounds constitutes good policy. First, it imposes a considerable informational burden on the public agencies to ascertain which exporting companies to support for the purpose of creating positive reputational effects.

Second, much of the reputational benefit is likely to be specific to the exporting firm rather than other potential exporters, giving the firm sufficient private incentive to promote its reputation. In addition, while a pioneer firm may initially face additional costs from the lack of established reputation, it may also capture significant private benefits in the long run, for example, from being the first mover into a new market. A firm with sufficient retained earnings or access to capital markets can absorb the losses that occur with initial exports and eventually make profits once country reputation has been established — making any case for government support correspondingly weaker (Panagariya 2000).

If it were the case that government determined a need to support pioneering firms to enter new export markets, it is likely that a more appropriate policy would be one that targeted information directly to likely buyers (Corden 1984). For example, a more direct approach would be to organise trade missions and exhibitions for exporters. Most state and territory governments maintain such programs (chapter 2).

The Commission is not referring in this section to a situation where a firm cannot obtain private sector support in a particular emerging market because of information failures relating to that market. That scenario could justify government intervention through EFIC and is discussed later in the chapter.

Offsetting domestic distortions that hinder exports

It has been argued that assistance to exporters is needed to offset existing distortions within the economy that hinder exports, such as tariffs (IC 1992). The idea is that by offsetting such distortions, an economy can specialise in producing goods and services according to its comparative advantage.

The optimal policy to address such concerns is to remove the source of domestic distortions directly rather than counter one distortion with another. Removing domestic distortions, such as tariffs, is desirable on efficiency grounds alone, regardless of their effect on exporting industries (Elbehri and Leetmaa 2001). Australia has benefited substantially from such reforms in the past:

> Reducing tariffs and eliminating quotas were tools of trade in fashioning the open, competitive economy, essential in exposing Australian business to international competition. (Emerson 2010)

There are also risks involved in enacting export policies to offset existing distortions within the economy. For example, in its review of export enhancement schemes, the Industry Commission (IC 1992) pointed out that export enhancement measures aimed at offsetting tariffs would create a group of exporters whose viability may depend on the maintenance of tariffs. Furthermore, ECAs and other export enhancing policies have the potential to introduce their own source of bias against the production of non-traded goods and services (Fitzgerald and Monson 1989).

Infant industry arguments

In international trade, the infant industry argument rests on the idea that a country may have a potential comparative advantage in a particular industry and that this comparative advantage cannot be realised without initial government assistance.

This may be because production involves learning by doing, which can lower costs and improve quality in the long run, or because a large volume of output is needed to achieve economies of scale. After an initial period of receiving assistance, the supporting industries should receive gains that more than offset their initial costs. NOJA Power has submitted that support of this nature is important:

> NOJA Power was the Australian Prime Minister's Exporter of the Year in 2009 as well as the Large Manufacturer of the Year, our company has created hundreds of millions of dollars in export revenue for Australia together with hundreds of jobs for Australians and we did this from our SME beginnings so it is important that more companies like NOJA Power are created and with EFIC's support for the SME sector that can be achieved. (sub. DR32, p. 1)

However, establishing the case for government intervention along these lines is problematic. First, it is unclear what market failure justifies the provision of assistance on infant industry grounds. If an industry would become viable after an initial establishment period and could communicate that to the market, private financial institutions should be willing to extend long-term finance that takes into account the expected stream of future revenue. If private financial institutions are not willing to lend due to a failure in the financial market, the appropriate policy is to correct those failures rather than provide assistance to specific export activities or particular exporters (Corden 1984).

Second, there are practical challenges including that government may not have the necessary information to judge that an industry will be able to export without assistance in the future after a period of initial support. Third, any such assistance needs to be temporary, requiring a determination by government of when the industry is no longer 'infant'. Australian experience with subsidies and tariffs has shown that withdrawing government support once it is provided is difficult as firms become dependent on it. Empirical evidence on the use of infant industry policies in Australia raises questions about the ability of government to successfully 'pick winners' or to terminate support after particular industries have demonstrated whether they are viable or not. For example, the textile, clothing and footwear and automotive industries in Australia still rely on government assistance to support production volumes after many decades of assistance (Banks 2008).

Export diversification

Quickstep argued that EFIC was needed to ensure a diverse domestic economy:

> Australia being a resource dominated economy in a country where the enormous majority of jobs are in the manufacturing and service industry creates a market imbalance that have wrecked a number of oil based third world economies and that can only be addressed by government policies that can insulate our industry from the

vagaries of the resource markets. The lack of such policies will lead to a gradual disappearance of whole sectors of the economy that will lead to Australia being unprepared for when the resource boom starts to dwindle and will leave high levels of unemployment now and thereafter. (sub. DR41, p. 1)

Agriculture and mining have historically played a prominent role in the composition of Australia's exports, with agriculture becoming less important since the 1970s. During the 1990s and early 2000s, concerns developed that the scope of exports was too narrow, especially given the burgeoning global information and communications technology industries. Australia was also perceived as representing an 'old economy', which could expect a long-term decline in its terms of trade (The Economist 2000). However, Australia's terms of trade are currently at their highest recorded level, driven by growth in China and India (Kearns and Lowe 2011). Advocates of government intervention prior to the sustained recent recession in Ireland, once pointed to Ireland — the 'Celtic Tiger' — and the activist strategies followed by its government to shape industry and exports, as policies the Australian government should follow.

The appropriate role for government is to ensure that resources move freely across sectors of the economy to the areas where they are most highly valued. Policy measures taken may involve for example, removing impediments to the mobility of labour. As noted by the Chairman of the Commission:

Ultimately, a dollar is a dollar, regardless of where it is earned or spent. All output uses scarce resources and a well-functioning, productive economy allocates those resources to where they can yield the biggest payoff. (Banks, 2011, p.11)

Exporting and multiplier effects

Some submissions to this inquiry have raised the issue of potential multiplier effects that arise from the promotion of export activity, and that their existence implies a rationale for government supported export finance and insurance by ECAs. For example, Santos submitted that as a result of EFIC's support for its Gladstone LNG project:

Santos has been able to make investments here in Australia which will directly create 5000 new jobs during construction and 1000 new jobs for the expected 30 year operation of Santos' GLNG project. The multiplier benefit for the local, state and national economies is significant in terms of additional jobs and investment, tax revenues and stronger communities. (sub. DR64, p. 2)

With reference to the Lumwana Copper Mine project in Zambia, Orpheus Geoscience submitted:

> … most of the contractors engaged for the construction of Lumwana were Australian companies … A significant proportion of the equipment and hardware at Lumwana have been sourced directly from Australia … benefits have been passed through to Australian superannuation funds by our many institutional investors, with flow on tax benefits to the Australian Government. (sub. DR62, pp. 1-2)

However, claims of the benefits of multiplier effects often overlook the opportunity cost of resources used — that is, the alternative uses to which those resources may have been put. As the Chairman of the Commission has argued:

> Just as the spending created in and by the recipient firm [of assistance] has multiplier effects, so too does the spending that is displaced from other firms and industries. Looked at another way, while public funds devoted to a project will have multiplier effects, those public funds would also have had multiplier effects if spent on other purposes, or left in the hands of taxpayers to be spent on the things that they value. (Banks 2002, pp. 8-9)

In short, there are multiplier effects associated with economic activity of any kind, be it export-orientated or otherwise. It does not follow that government resources, that could be used elsewhere, should be allocated to EFIC on the basis that its activity generates multiplier effects. Government investment in education, for example, also generates multiplier effects in the economy.

In the case of resource projects, such as the Santos project mentioned above, government assistance may simply bring forward activity that would have occurred at a later date, rather than lead to activity that would not have occurred at all. There will be circumstances where artificially accelerating a project is not efficient, particularly where resources are diverted from other productive activities. Multiplier analysis in such cases is likely to be of little value.

At any rate, as discussed in chapter 4, it is best to target any policy problems at the source rather than attempt to calibrate policy to achieve indirect flow-on effects.

Offsetting export assistance by foreigners

Many participants to this inquiry argued in favour of general assistance to export industries on the grounds that other countries subsidise their exports, and therefore, Australia should do the same. Two variations on this argument are that every developed country has an ECA and, therefore, Australia needs one to be competitive; and linked to that, export assistance for a particular project is warranted because, in its absence, another ECA would step in and fill that role. The basis for this argument is that a failure to match export enhancement offered by other countries unfairly disadvantages exporters and may lead to the dislocation of industry (Fitzgerald and Monson 1989).[1]

Codan Ltd, for example, stated:

> If Australia does not have an Export Credit Agency (ECA) with the capacity and competency to support Australian companies competing against foreign companies who do have support of their own ECAs then Australian companies will be placed at a severe disadvantage. (sub. DR65, p. 1)

This proposition seems to run contrary to the fact that the vast majority of Australia's exporters are able to trade in international markets without EFIC's assistance.

It is not clear that any government response to foreign ECA activity is needed. Where the assistance offered in other countries is necessary to address a market failure in that country, the assistance is efficiency enhancing and requires no response by the Australian Government. Even where foreign assistance does not address a market failure, and constitutes a subsidy to foreign exporters, it is the importing nation that is usually the beneficiary of such assistance. As NERA pointed out in a review of the UK's ECA:

> In the context of maximising national welfare, economic trade theory gives some clear prescriptions about the effectiveness of export subsidies. If two countries are trading with each other in competitive markets, and one decides to subsidise its exports, this reduces welfare in the subsidising country and increases welfare in the other country. The reasoning is simple: through using tax revenues to provide the importing country with subsidised imports, the export subsidiser is simply transferring resources to the other country. The appropriate response from the other country is not to retaliate, but simply to enjoy the welfare gains provided by the export subsidies. (2000, p. 71)

Taking the export subsidies of foreign governments as given, a subsidy to Australian exporters in the absence of a market failure would result in a net loss of welfare in Australia. Although the subsidy would provide a benefit to exporters disadvantaged by foreign subsidies, this would be outweighed by the cost of the subsidy.[2] There is also the additional risk that retaliatory subsidies may lead to a further escalation of subsidy provision by foreign governments. This has the potential to lead to a spiral of distortion or misguided investment in seemingly promising areas (IC 1992). A more efficient policy response is for all countries to

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1 Where Australia is a net exporter of the commodities in question.

2 In a perfectly competitive export market, assuming Australia is unable to alter the world price of exports (the 'small' country assumption), the gains in producer surplus arising from a subsidy are less than the cost of providing it, leading to a deadweight loss.

remove assistance to their exporters. Doing so ensures that world trade flows are guided by comparative advantage, increasing the welfare of all nations involved.

What implications do the policy goals of foreign ECAs have?

EFIC has also pointed out that other ECAs often have explicit mandates to pursue policy objectives such as resource security, or ensuring that regional infrastructure is not a brake on domestic growth (EFIC 2012e). It stated that:

> Such activities are feeding concerns that non-OECD ECA offshore investment financing, both tied and untied to exports, may be distorting international purchasing and investment decisions as firms from these countries are receiving subsidised financing and buyers are attracted by the absence of the 'conditionality' associated with other financing sources. (EFIC 2012e, p. 11)

It further noted:

> The activity of Non-OECD ECAs which are not subject to the pricing and condition guidelines enshrined in the OECD [Arrangement on Officially Supported Export Credits] may prompt OECD nations to engage in 'matching.' (EFIC 2012e, p. 11)

The Commission considers that the policy ramifications of such concerns are broadly analogous to the case of responding to other countries' tariffs by imposing tariffs domestically. The adoption of such a policy (even without retaliation) will disadvantage Australia by increasing domestic costs. Using EFIC to match other countries' subsidies would be counter-productive.

Facilitating participation by other ECAs

Several participants (EFIC, sub. DR90; Macquarie Group, sub. DR45; King & Wood Mallesons, sub. DR84) argued that EFIC's participation acted as a catalyst for other ECAs to become involved in the project. NAB observed:

> For projects in Australia, EFIC serves as a catalyst for participation of other ECAs which are not as familiar with the country. (sub. DR92, p. 3)

Latham and Watkins claimed:

> In our experience, EFIC's participation in a project often is able to be used to attract other ECAs to participate in providing financial support to that project. We experienced this in the PNG LNG transaction and we are seeing it in the liquefied natural gas project in Australia on which we are working presently. EFIC is seen as a leader within the ECA community and is viewed by other ECAs as technically proficient in assessing the risks associated with such complex projects. (sub. DR51, p. 2)

The Commission considers this argument is unsound. It is unclear what the counterfactual level of foreign ECA participation would be in EFIC's absence. As noted by EFIC in its submission to the *Australia in the Asian Century* White Paper, several foreign ECAs have increased their activity in Australia, driven largely by domestic policies of their respective governments:

> EFIC notes the increasing presence of Japanese, Korean and Chinese ECAs in Australia, most notably in sectors such as LNG, mineral resources extraction and associated infrastructure upgrades (port and rail) and loan support to their national companies' investment in Australia reflecting the broad 'national interest' objectives outlined above. (EFIC 2012e, p. 7)

More importantly, the Commission does not consider that facilitating participation by foreign ECAs is an appropriate objective for policy. There is no intrinsic benefit arising from increased presence of foreign ECAs and no evidence of a market failure preventing the support of Australian exporters by foreign ECAs has been presented to the Commission.

The Commission also notes that EFIC has made several observations about foreign ECA activity in Australia — some indicating that foreign ECA investment is beneficial to the Australian economy and should be facilitated, others that they are a potentially negative influence (box 5.1).

Box 5.1 **EFIC's views on foreign ECA activity in Australia**

The Commission has found it difficult to determine EFIC's views on foreign export credit agency (ECA) activity in Australia. In some cases EFIC has indicated that it viewed it positively, while in others it cautioned about the potential downsides to foreign ECA activity.

EFIC stated that foreign ECA investment in Australia is an important source of capital:

> ... ECAs are a vital channel through which Australia imports the capital it needs to supplement its limited domestic savings capacity. (sub. DR90, p. 69)

EFIC also claimed that it encouraged foreign ECA investment in Australia:

Offshore ECAs, including from Asia, Europe and North America, are increasing their commitment to the Australian market to support many of these [onshore resource] projects. EFIC plays an important role in facilitating foreign ECA involvement and ensuring that commercially viable projects are successfully financed. (sub. DR90, pp. 69–70)

(Continued next page)

Box 5.1 (continued)

On the other hand, EFIC's Managing Director and CEO, Mr Angus Armour was reported to have expressed misgivings that this investment may come with 'strings attached' and may disadvantage some Australian firms:

> Having them [foreign ECAs] fund the development of our resource economy from the perspective of GDP growth is a good thing, but obviously there are strings attached ... The string that we look at most closely at EFIC is they're funding in order to create jobs for their exporters ... Australian companies are competing against foreign companies backed by their [export credit agencies]. (Sydney Morning Herald,15 March, C. Yeates)

EFIC also told the Commission that, without its participation, foreign ECAs investing in Australia may take actions that are not in Australia's national interest. For instance:

> ... in the event of a loan default, the creditor i.e. the foreign ECAs are able to make decisions without need for Australian government approval to maximise their recovery, in doing so the action taken may not be in Australia's interest. (sub. 18, appendix A, p. 46)

But despite these misgivings, EFIC informed the Commission it was comfortable with foreign ECAs investing in Australia without its involvement:

> And if the [foreign] export credit agencies who may be involved in a particular project are equally comfortable to go ahead without us, then there is no need for us. (trans., p. 301)

Finally, despite claiming that much of the foreign ECA activity in Australia was a direct result of EFIC's facilitation activities, EFIC has argued that foreign ECA investment in Australia was a natural consequence of the 'market gap':

> The 'market gap' rationale that underpinned EFIC's establishment has never been more evident. The level of ECA activity in Australia and overseas demonstrates that the implications from the GFC and Euro-zone crises continue to play out in credit markets. (sub. DR90, p. 10)

5.3 Specific problems in export finance and insurance markets

Government provision of export finance and insurance is sometimes suggested on the basis that there are impediments in finance and insurance markets that result in inefficient outcomes. These impediments include: government's superior capacity in managing and bearing risk; lack of effective competition among providers; regulatory distortions; systemic problems in financial markets; international financial crises; and information problems.

Sovereign risk

Sovereign risk can affect both importers and exporters (chapter 3 contains a discussion of risk, including the distinction between sovereign risk and country risk). For example, an exporter faces the risk that the government of the importing country might pass laws unfavourable to the firm, damaging its business prospects or its ability to repatriate funds.

In other cases, governments may be a party to an export transaction through, for example, the provision of a performance bond on behalf of an exporter or a sovereign (a guarantee if the foreign borrower cannot provide the lender with an appropriate asset to use as security). In the latter case, the lender must rely on the incentive of the foreign borrower's government to honour the guarantee if it is called. If this incentive is weak, private sector providers may be unwilling to lend against a sovereign guarantee, particularly as the lender has little recourse due to the absence of legal mechanisms to enforce the guarantee contract (Eaton 1986). Similarly, buyers will discount the value of a performance bond provided by a foreign government if they do not consider it likely the contract will be honoured.

Some have argued that the involvement of ECAs should be used to overcome such risks. For example Latham and Watkins argued:

> … where an ECA is providing credit support, the host government may be less likely to take action that would be objectionable to the government of the ECA's home country, such as expropriating assets or nationalising industries. In addition, ECAs may be able to facilitate more effective government-to-government solutions via channels not available to the private sector. (sub. DR51, p. 3)

In the case of sovereign loans, private sector refusal to support transactions with particular countries may be a rational response to past default. One mechanism used to encourage governments to repay their loans is to exclude them from access to capital markets in the event of non-payment:

> A default against one borrower is treated as a default against other borrowers, and all are required to impose an embargo … Lenders perceive borrowers who have defaulted in the past as more likely to default on subsequent loans. (Eaton 1986, p. 131–132)

This course of action has been undertaken in the past. Feinberg (1982), for example, reports that in the mid-1970s several members of the Berne Union declared Pakistan ineligible for long-term loans.

Cross-border contractual or regulatory problems

EFIC also claimed that its status as a government agency brings advantages in averting or resolving cross-border disputes arising from poorly developed legal and regulatory systems in other countries:

> Companies are willing to do business with an ECA even if a contract can't be made watertight, because it perceives that the 'Australian Government crest' brings with it a

> reputation to uphold, that it will follow due process and will not make arbitrary decisions or reject claims on unsubstantiated grounds. It is often reported that EFIC's presence in a transaction provides comfort to exporters, investors and even co-lenders. This can be the case, particularly in frontier or emerging markets where legal systems, or the application of the legal framework may not be as developed. (sub. 18, appendix A, p. 9)
>
> EFIC may not be the most effective mechanism for addressing regulatory barriers that exist in the banking system generally, but can be the best mechanism to address regulatory distortions overseas in the provision of export and trade finance. (sub. DR90, p. 19)

Similarly, the ANZ claimed:

> EFIC is at times able to resolve issues in a more timely manner through government to government contact. (sub. 20, p. 4)

The Commission does not consider that this is a strong argument for government provision of export finance and insurance, in part because it is not clear that EFIC has particular advantages over its private sector counterparts in enforcing contract terms. Further, it is not clear that in the event of non-payment, EFIC's ability to secure repayment is superior to other agencies of the Australian Government, such as its diplomatic representatives in the country concerned.

Furthermore, as the Department of Foreign Affairs and Trade (DFAT) noted, about 30 per cent of EFIC's transactions were outside of emerging, frontier, and transitional economies (sub. 19).

If it is the case that the Australian Government's reputation is being used to support transactions associated with poorly specified contracts or in countries with less developed regulatory systems, the risk of those transactions is being transferred from EFIC's clients onto the Australian Government. Drawing on the political and diplomatic capital of government is not costless and such actions may not always be aligned with foreign policy objectives. It is not clear that EFIC is able to recoup the cost of providing any intangible benefit of reputation and 'government to government' contact from its private sector partners in those transactions.

Government as the bearer of risk

Government provision of export finance and insurance is sometimes defended on the grounds that the time horizon of private sector providers is too short and that long-term projects deserving of finance and insurance cannot obtain it. EFIC (sub. 18) argued that the private sector has an insufficient risk appetite, and fails to finance and insure many profitable, but risky projects. EFIC also noted in its submission to the draft report:

> The critical difference in EFIC's coverage relates to the risks that EFIC is prepared to assume on behalf of exporters due to an absence of private sector risk appetite and/or capacity availability. (sub. DR90, p. 14)

EFIC further argued:

> Thanks to the government's superior capacity to bear and pool these risks, it is also legitimate for government to earn a lower return on the equity it has invested in EFIC on behalf of taxpayers than private shareholders are entitled to demand of private companies. (sub. DR90, pp. 87-8)

However, private sector providers will base their decision on whether to finance a given project based on the risk of the project, the expected return, and the risk preferences of the institution. The fact that the private sector is more willing to extend finance and insurance to some projects rather than others based on considerations of risk, does not constitute market failure. As noted by NERA (2000), risk aversion simply reflects the preferences of economic agents between more certain outcomes and riskier outcomes. It is unclear why the public sector should override the preferences of financiers and insurers if they prefer less risky projects to riskier ones, especially when the risk concerned is not the result of market failure.

Government as the bearer of risk — the flaws in the argument

EFIC has claimed that government provision of export finance and insurance may be justified, because governments are better able to bear the relevant risk:

> First, those risks are often large, long-term and positively correlated. Second, the government can spread and pool risks more widely than the market can, because it has the government balance sheet, faces limited threat of bankruptcy, and has a first-mover advantage. (sub. 18, appendix A, p. 12)

EFIC cited four studies to support this claim — Stephens (1999); Moser, Nestmann and Wedow (2006); NERA (2000); and Ragan (2008). The Commission examined those studies and did not find compelling evidence to support EFIC's argument (box 5.2).

First, intervening on this basis would distort the allocation of resources away from activities offering greater returns to the Australian economy. Second, as the events following the European debt crisis demonstrate, even governments in large economies are not immune from the threat of bankruptcy. More importantly, a low threat of government bankruptcy is more likely to dull governments into understating the risk of intervening and the consequences of commercial failure. Direct intervention in financial markets without a strong market failure rationale and in the absence of strong governance controls can be expected to impose significant costs on taxpayers.

Box 5.2 **Government as the risk bearer — research presented by EFIC**

In looking at the export promotion effect of the German export credit agency (ECA), Moser, Nestmann and Wedow (2006) listed the potential reasons for the private sector not supplying trade finance, but did not discuss how governments could resolve this at a lower cost than the private sector. They also noted:

> It is important to bear in mind that we only tackled one of the issues central to an overall assessment, encompassing benefits and costs of an export credit agency. With respect to the latter, questions about the costs of public export intervention (e.g. the considerable losses accumulated by Hermes in the 1980s and early 1990s, which consequently had to be covered by the state budget) and possible market distortion stemming from the state interference are beyond the scope of this paper. (p. 18)

Similarly, Stephens (1999) listed the various reasons for the private sector not covering some political risks, but did not provide any evidence that governments were better able to perform that role.

In contrast, NERA (2000) explicitly argued that governments had an advantage over private sector participants in bearing risk. However, its argument rested on two questionable assumptions. First, it argued that the ability of a private provider to spread and pool risks was limited to the size of its trade finance arm, thereby ignoring the scope to spread and pool risks across the entire firm or to enter into syndicates with other providers — a common practice for large trade finance and insurance transactions. In contrast, NERA argued that the risk spreading and pooling ability of an ECA was not limited to the ECA but spanned the entire pool of government assets and the entire population of taxpayers. Second, it assumed that governments faced no risk of bankruptcy — a claim not supported by recent events in Europe.

Finally, in a paper prepared for the Canadian ECA, Ragan (2008) claimed that governments had a higher tolerance for risk than the private sector because of their longer-term perspective on profits and being better able to stay 'on risk' during temporary disruptions. However, the paper provided no evidence to support this claim.

Ultimately, the Commission disagrees with the argument that government should provide export finance and insurance because it is better able to bear the risks by virtue of its size and scope of operations, or because it can absorb sub-commercial returns on its investments. In the absence of a clear explanation of the boundaries for government involvement on these grounds (and the rationale for those boundaries), this logic would suggest that all risk in the economy should be borne by government.

Effective competition in financial markets

The banking sector in Australia is dominated by the 'big four' commercial banks — the ANZ, Commonwealth Bank of Australia, NAB and Westpac. The oligopolistic structure of Australia's banking sector is sometimes argued to lead to a lack of effective competition, a socially suboptimal quantity (and quality) of banking services, highly profitable banks and a relatively high level of concentration in the banking sector (Davis 2011; SERC 2011).

International comparisons using a number of measures show concentration in the Australian banking system (pre-global financial crisis (GFC)) to be similar to those overseas (Stevens 2009a; RBA 2010a), although it is unclear what the current position is. In any case, aggregate measures of banking activities used for analysis disguise the degree of competition in different market segments, making it difficult to ascertain whether markets for export finance and insurance are affected by any lack of competition.

The concerns about lack of effective competition in the financial sector often relate to the access to finance by SMEs. The Senate Economic References Committee reported:

> The increase in margins on small business lending, and some complaints about lack of finance, suggest that competition may not be as intense as it should be in the market for lending to small businesses. (SERC 2010, p. 37)

This echoes some comments heard by the Commission in consultations — that private financial institutions have little interest in some segments of the market. For example, Australian Services Roundtable reflected:

> The policy framework that has locked in place four strong domestic banks has not been helpful in building the international linkages and credit assessment capabilities needed by Australian exporters; however reform of Australian banking involves issues beyond export credit. (sub. DR114, p. 2)

In its submission to the inquiry into competition within the Australian banking sector, the Reserve Bank of Australia noted that, in recent years, some lessening of the degree of competition in lending has occurred, although competition to attract deposits has increased. At the same time, with the exception of a brief spike in 2010, in the past few years bank margins have fluctuated in a narrow range of about 2.25 per cent to 2.5 per cent (RBA 2012c).[3] Although the stability of the

[3] In the same publication, the Reserve Bank of Australia noted that underlying profits have generally increased in the first half of 2011-12.

financial system is crucial, protecting and promoting competition should also be central to considerations regarding regulation of the industry.

A review of the competition provisions of the *Trade Practices Act 1974* (Cwlth) (known as the Dawson Review) was undertaken in 2003 and considered issues of potential anti-competitive conduct. However, a wide ranging review of the structural characteristics of the financial sector in Australia has not been undertaken since the Wallis Committee's 'Financial System Inquiry' of 1997 (Wallis et al. 1997).

A number of recent parliamentary inquiries have reported on topics related to competition in the finance sector (HRSCE 2008; SERC 2009, 2011). These inquiries generally note that evidence is mixed on whether the Australian banking sector lacks effective competition. The Australian Government Treasury, however, considers there is a need for a broad ranging review of the finance sector to ensure there is competitive pressure. In its *Red Book* submission to the incumbent Government, released under the *Freedom of Information Act 1982* (Cwlth), the Australian Government Treasury recommended:

> ... initiating a comprehensive financial sector review in order to take stock of the lessons of the financial crisis and draw together the work currently being undertaken both here and internationally (Department of the Treasury 2010, p. 3).

It also stated:

> Australia has not undertaken a comparable review since 1997 and we strongly urge you to make this a key priority in your second term ... (p. 36)

The most appropriate mechanism for increasing competition in finance markets

Competition issues in financial markets affect all sectors of the economy (not just exporters) and the appropriate intervention by government should apply to the finance industry as a whole, rather than just exporters. The Commission also notes that frameworks are in place to deal with some of the most serious concerns that arise from a lack of effective competition. At present, in addition to bank merger powers vested in the Treasurer under the *Banking Act 1959* (Cwlth), the Australian Competition and Consumer Commission has regulatory responsibility for financial institutions that includes:

- consumer protection
- prevention of abuse of market power in certain circumstances
- reviewing corporate mergers to ensure they do not result in anti-competitive outcomes.

However, these policy tools alone could not be used to deliver structural reforms similar to those that shaped Australian financial markets in the 1980s.

Regulatory distortions in export finance and insurance markets

The regulation of financial markets may adversely affect the supply of export finance and insurance. For example, regulation can cause frictions that limit the banks' or insurers' ability to adjust to changing business circumstances (Chauffour and Farole 2011).

Reviews of Australia's financial sector undertaken in 1981 (the 'Campbell inquiry') and 1996-97 (Wallis et al. 1997), report that, on balance, the system has performed well and appears to be well respected. Australia's regulatory system has a favourable international reputation with aspects often used as a model for reform in other economies (Davis 2004). For example, a review by the Regulation Taskforce noted:

> … several challenges need to be addressed to further promote a balanced and efficient regulatory environment in the financial and corporate sectors. However, it is important to keep these in perspective. Australia's financial and corporate sectors, and the associated regulatory structures, are highly regarded internationally. Moreover, the broad policy framework has widespread support within business and the wider community in Australia. (Regulation Taskforce 2006, p. 88)

In any case, the Commission considers that EFIC is unlikely to be the most effective mechanism to deal with any distortions created by regulation. Offsetting a distortion created by regulation faces a number of implementation problems. Often it is difficult to measure the exact size and distribution of the distortion created by the regulation, and the same difficulties arise when designing policy to counter those effects. In the case of export markets, doing so may create further distortions that undermine the principle of comparative advantage, and lead to an inefficient allocation of resources, domestically and internationally.

In light of these problems and costs, the Commission considers that more direct ways to address any distortions created by regulation would be preferable. Ideally, policies to reduce these burdens would examine and redesign the regulations themselves with the aim of minimising cost.

Systemic failures in global financial markets — imbalances in supply and demand?

It is sometimes claimed that the global supply of financial services is either insufficient or misallocated due to failures in international financial markets and that ECAs can play a role in addressing these failures. The ANZ noted:

> In ANZ's experience the issues regarding access to finance are primarily related to the imbalance in supply and demand. (sub. DR101, p. 5)

In Australia's case, the argument has been advanced in the context of the availability of finance for large resources projects. The ANZ further stated:

> This contraction in participants supplying credit and liquidity capacity is occurring at a time when demand is expected to increase exponentially. ANZ research shows the project finance market in Australia was A$10.4bln in 2010 and A$15.2bln in 2011. ANZ expects the Project finance debt requirement to be A$109bln in 2012 … and A$120bln in 2013. (sub. DR101, p. 5)

EFIC argued:

> It is true that the commercial market for financing such assets is highly developed with financing structures, terms and conditions including credit costs and equity returns being appropriate and widely accepted. Yet the issue is volume; the private sector debt market has failed to deliver the quantity of debt necessary to finance these viable projects. There will be an even greater demand for ECA financing of onshore resources projects going forward, with large-scale investment required to meet the continued demand for resources largely from Asia ... the size of the projects currently in planning or under development far exceed the capacity of global financial markets, even in normal (pre-GFC) market conditions. (sub. DR90, pp. 69-70)

EFIC further stated:

> … a case can be made for an ECA such as EFIC to address shortfalls of external financing caused by [overseas market] failures. This argument has special force in a country like Australia, which has a structural surplus of investment opportunities over domestic savings capacity, and therefore needs to import large sums of foreign capital. (sub. DR90, p.88)

The Commission has previously noted that 'massive flows' of new capital have come to Australia to support projects in the resources sector (Banks 2011). However, the market failure basis for government intervention to overcome imbalances in the supply of, and demand for, capital needs to be established and supported by evidence. Imbalances in supply and demand are not in and of themselves a market failure — changes in supply and demand happen in all markets and the balance is restored over time through a change in the market price.

For example, the fact that a project that may become viable in the future is not supported today, may simply reflect the opportunity cost of the resources involved at the time and the decision by the private provider on how to maximise the value of its resources across time. There is no intrinsic value in accelerating the completion of an export project (or infrastructure-related project) that is non-commercial now, over waiting until market conditions are sufficient to ensure commercial supply. It is prudent to use Australia's resources when demand warrants it and not before (otherwise the outcome is a subsidy to overseas consumers and a distortion in the Australian economy).

The Commission considers the evidence on the availability of capital for large resource projects in chapter 7. Further, as discussed in chapter 4, even if a failure in financial markets is established, the appropriate response typically involves more targeted policies such as reforming prudential regulation and removing the policy distortions affecting markets.

FINDING 5.1

The following arguments are not sound policy rationales for government involvement in export finance and insurance through EFIC:

- *EFIC can assume more risk than the private sector is willing to accept because it is government owned.*
- *EFIC is necessary to address cross-border regulatory problems faced by exporters.*
- *EFIC can be used to address problems arising from insufficient competition in Australian financial markets.*
- *EFIC can address imbalances in the supply of, and demand for, capital.*

International financial crises

The GFC in 2008 and 2009 saw a significant fall in the global demand for goods and services, falling asset prices, and a general increase in perceived systemic risk in financial markets and financial systems (Stevens 2009b). Submissions showed widespread support for the proposition that significant market disruptions of this kind may justify government intervention through EFIC. For example, the ANZ argued that it is important that EFIC is able to operate when markets are unstable as 'EFIC involvement reduces risk for commercial banks and can be a catalyst for private sector participation' (ANZ, sub. 20, p. 4).

Many of EFIC's customers were also supportive of this position. For example:

> The GFC was a devastating example of market failure. Banks throughout the world withdrew credit to companies having little regard to the consequences and without taking into account their credit worthiness. Australian exporters who had assistance from EFIC during this time (whether they were large or small) were able to continue to operate. (McConnell Dowell, sub. DR29, p. 1)

> We would judge the requirement for significant amounts of cash backing as a market failure, since it reflects an anomalous situation stemming from the GFC credit crisis from which financial markets have yet to fully recover. (Greyhound Australia, sub. DR 59, p. 3)

In addition, EFIC stated:

> An ECA can perform a particularly important service during a financial crisis. It can step forward with support of exports as the private sector steps back, thereby cushioning a slump of exports … Most recently in response to the GFC, EFIC increased its support for exporters in response to a number of market gaps that arose during and following the GFC. It also modified its existing products to reflect the private sector's reduced risk appetite and constraints on exporter credit. (sub. 18, p. 7)

World Bank researchers conducted a survey to investigate the anecdotal claims that trade finance dried up in some developing countries during the GFC. Malouche (2009) details the results of this survey of 425 firms and 78 banks in 14 developing countries[4] in 2009 and, despite finding some evidence of tighter conditions for trade credit, concluded:

> ... the drop in volume [of trade credit] seems to reflect lack of demand due to the global recession rather than a consequence of the increase in pricing. (p. 6)

Similarly, OECD researchers Cheung and Guichard (2009) concluded that 'most of the trade collapse can be explained by world demand' and that 'tight credit conditions have likely amplified the short-term trade response' (p. 24).

A study conducted by researchers at the International Monetary Fund (Asmundson et al. 2011) looked at the changes in and interrelationship between trade finance and trade volumes during the GFC for a wider range of countries. Four surveys of commercial banks were undertaken between December 2008 and January 2010 to obtain information on the changing nature of market conditions for trade finance. Even though the value of trade finance was lower at the height of the GFC than before it, it fell by less than the value of merchandise trade in most regions of the world. By the final quarter of 2009, both trade and trade finance volumes were beginning to recover. The study also found that the share of world

4 The 14 countries were: Brazil, Chile, Egypt, Ghana, India, Indonesia, Kenya, Peru, the Philippines, Sierra Leone, South Africa, Tunisia, Turkey, and the Ukraine.

trade supported by bank-intermediates actually increased during the GFC. The study's authors attributed this to increased risk aversion by exporters, seeking protection from risk. Accordingly, Asmundson et al. (2011) concluded that the causes of the increased price and decreased value of trade finance were mainly spillovers from financial markets and the decline in international trade associated with recessionary conditions.

In their discussions with the surveyed banks, Asmundson et al. (2011) found that the banks attributed most of the changes in the consumption and provision of trade finance to changes in the demand for traded activities (table 5.1). The behaviour of financial intermediaries providing trade finance services (including ECAs) was less important relative to changes in demand.

Table 5.1 **Reasons cited for changes in the aggregate value of trade finance**

Increases in the value of trade finance[a]		*Decreases in the value of trade finance*[b]	
Reason	*Per cent*	*Reason*	*Per cent*
Increased demand for trade activities	72	Decreased demand for trade activities	85
Increased price of transactions	34	Decreased price of transactions	38
Increased credit availability at own institution	30	Lower credit availability at own institution	30
Increased credit availability at counterparty banks	12	Lower credit availability at counterparty banks	30
Shift away from open account transactions	28	Shift towards open account transactions	23
Shift away from cash-in-advance transactions	22	Shift toward cash-in-advance transactions	21
Increase in support from ECAs	14	Decline in support from ECAs	8
Increase in credit from multilateral institutions	14	Decline in credit from multilateral institutions	0
Other reasons	13	Other reasons	18

[a] Based on 76 respondents that reported an increase in the value of trade finance in at least one geographic region in the IMF/Bankers' Association for Finance and Trade-International Financial Services Association March 2010 survey. [b] Based on 61 respondents that reported a decrease in the value of trade finance in at least one geographic region in the IMF/Bankers' Association for Finance and Trade-International Financial Services Association March 2010 survey.

Source: Asmundson et al. (2011).

Another group of OECD researchers (Korinek, Le Cocguic and Sourdin 2010) similarly concluded that the quantity of short-term trade finance 'put into motion' through insurers fell later, and by less, than flows of general short-term finance. One potential reason the authors advanced for this result is the possibility that trade finance may be less risky to banks and insurance companies than some other types of transactions.

Recent research affirms these general results. For example, Eaton et al. (2011) concluded that the majority of the decline in international trade during the GFC was caused by changes in the demand for traded goods. Indeed, their model suggests that the decline in total manufacturing demand that occurred in 2008 and 2009 accounted for about 80 per cent of the decline in the ratio of global trade to GDP. Likewise, the IMF (2010) found that the decline in final demand accounted for more than 70 per cent of the observed trade collapse.

At the time, EFIC's Managing Director and CEO Angus Armour noted:

> … there are anecdotes of people having difficulties in obtaining trade finance, but EFIC 'is struggling' to find data to confirm these reports. At this point, trade is falling because the global economy is slowing, and trade finance is reflecting the slowing economy. (Asia Today Online 2009)

Hence, the evidence suggests that constrained supply of trade finance was not the major cause of the decline in the value of international trade that occurred during the GFC. Rather, the primary cause appears to have been lower demand for traded products. Furthermore, the decline in the availability of credit was likely to have been, at least partially, an efficient response to prevailing conditions. In that light, attempts to artificially restore credit, through ECA provision or otherwise, run the risk of creating further inefficiencies in financial markets.

EFIC has acknowledged that the Commission's finding that constrained supply of trade finance was not the major cause of the decline in world trade is 'consistent with EFIC's advice to Government in 2009' and that:

> EFIC consistently recommended to the Minister for Trade not to intervene in short-term trade finance during the depths of the GFC. This was also EFIC's advice to senior officials in the Department of Foreign Affairs and Trade (DFAT), Department of the Treasury (Treasury) and the Department of Finance (Finance). (sub. DR90, p.20)

However, EFIC further stated that 'it is still the view of some researchers that a shortfall in trade finance was, at least, a moderate factor in the 2008-09 world trade slump' (sub. DR90, p. 20). The Commission considers that the weight of evidence indicates that a decline in demand was the primary cause of the decline in world trade flows.

EFIC also claimed that ECAs can play a signalling role in financial crises, such as the GFC and the 1997 Asian financial crisis, by reassuring the private sector that official institutions stand ready to provide backup during times of financial difficulty (sub. DR90). EFIC cited the example of the Asian financial crisis and its provision of short-term insurance services because exports from Australia to Korea and other Asian countries 'came under severe threat' as an appropriate government response until support could be considered on the national interest account (sub. DR90, p. 21).

Further examination of the appropriate basis for government to intervene in financial markets during times of market disruption is presented later in this chapter. However, the Commission does not consider that intervention for the purpose of ameliorating falling demand for exported goods and services from Australia is an appropriate role of government. As noted by Mr Malcolm Stephens, a former secretary-general of the Berne Union, ECA support during the Asian financial crisis 'did not cause or prolong the problem, they did not contribute significantly to a solution' (1998, p. 1).

FINDING 5.2

The decline in the provision of trade finance during the global financial crisis was primarily due to lower levels of international trade and resulting lower demand for trade finance products. As such, government policy aimed at ameliorating the decline in international trade through the provision of export finance and insurance through EFIC would not have been successful.

Information as a public good

Some information has public good characteristics that may warrant government intervention (Sandall, Kaine and Johnson 2009). Information by its nature is non-rivalrous — consumption by one person does not affect the amount available to others. In some cases, after it has been produced and disseminated or even used in a way that can be observed by others, it may become non-excludable — other people can take advantage of the knowledge without paying for it. Broader categories of information used in trade finance, such as country and market risk may fall into this category.

EFIC argued that a lack of information on international markets can impede access for exporters (EFIC, sub. 18) and that:

> [it has an] advantage in assessing many of the risks that beset exporters, e.g. country risk. [This is a] reason for EFIC to provide information – and maybe even to 'signal' its attitudes by providing cover (sub. DR90, pp. 84–6).

In some circumstances, governments may be naturally placed to generate and disseminate information that has public good characteristics and this can be an efficient means of overcoming associated market failures. EFIC and other government agencies such as Austrade publicly release information, including country risk assessments, that assists exporters, importers and private sector providers to assess the risk of dealing in a particular country (chapter 3 and box 5.3). It should, however, be noted that much of this information is also available from the private sector (chapter 3).

Box 5.3 **Public information provided by EFIC**

EFIC provides some public information on the nature of finance and insurance markets for exporters and on the riskiness associated with exporting to some countries. EFIC's economics team compiles a list of country profiles that contain economic background on the countries covered and highlight some of the risks exporters may face in sending goods or services to those countries.

For example, in its country profile of Nigeria (published in November 2010), EFIC ranks a number of risks for exporters as being 'very high' (on a scale that ranges from 'negligible' at the lower end to 'extreme' at the higher end). EFIC regards business cycle, currency, currency inconvertibility, systematic banking and sovereign default risks in Nigeria as 'very high'.

EFIC's economics team also writes a monthly email newsletter 'World Risk Developments' aimed at exporters and overseas investors. It focuses on issues such as exchange controls, expropriation, and political violence, and is available for no charge. Also available is a chartpack, which provides a monthly summary of world economic conditions and an annual Global Readiness index (a study of Australian export and investment destinations, their motivations, and barriers faced by Australian businesses).

The Export Finance Navigator — a website developed and sponsored by EFIC — provides information on commercial export products and government grants. This site contains information on products provided by commercial banks and also gives information on grants and tax concessions provided by all levels of government, broken down by stage of export activity (for example, winning contracts or financing production).

Asymmetric information

Asymmetric information in financial markets can potentially lead to market failure. The market failure and the resulting inefficiency arise when the asymmetry encourages the behaviours of adverse selection and moral hazard. A related problem is that of credit rationing which can also arise in financial markets where this asymmetry is present.

Adverse selection and moral hazard

If one party to a transaction cannot observe all of the relevant characteristics of the other party, or the quality of the good or service provided by the other party, this may result in adverse selection (box 5.4). If severe enough, to the point where a service provider such as an insurance company, cannot distinguish between different types of consumers (for example, whether consumers are high or low-risk types) markets may break down entirely.

The presence of asymmetric information in export finance and insurance markets may lead to adverse selection, such that certain types of exports do not receive financing, or particular risks go uninsured by the private sector. This situation may potentially be remedied through government provision of information or, where more efficient, the provision of export finance and insurance.

Box 5.4 **Adverse selection: a simple example**

Consider an insurance market that consists of two types of potential purchasers of insurance: high-risk and low-risk and that the insurance company cannot distinguish between high and low-risk purchasers.

An insurance company could simply charge a separate premium to each group reflecting their relative risk where it is able to distinguish between the two purchasers. Where it is not possible to distinguish between them, the insurer may instead charge a premium based on generic or common risk characteristics of the purchasers or a relatively well defined class of relevant purchasers.

In this case, low-risk purchasers will not be willing to purchase insurance since the premium charged exceeds their expected loss. The only customers willing to purchase insurance at this price would be the high-risk ones. Low-risk purchasers would exit the market and self-insure, leaving only high-risk ones remaining, resulting in adverse selection.

Moral hazard arises when one party to a transaction does not bear the full cost of its actions and, therefore, has a tendency to act less carefully, at the cost of the other party to the transaction. For example, a firm may reduce its effort in lowering the commercial risks covered by an export insurance policy after it is issued, thereby increasing the likely costs for the insurance provider.

Credit rationing

There is economic literature discussing the link between suboptimal credit rationing and imperfect information (for example, Stiglitz and Weiss 1981; Rothschild and

Stiglitz 1976; Wilson 1977; Clemenz and Ritthaler 1992). Stiglitz and Weiss described this link:

> … the interest rate a bank charges may itself affect the riskiness of the pool of loans by either: 1) sorting potential borrowers (the adverse selection effect); or 2) affecting the actions of borrowers (the incentive effect). Both effects derive directly from the residual imperfect information which is present in loan markets after banks have evaluated loan applications. When the price (interest rate) affects the nature of the transaction, it may not also clear the market. (1981, p. 393)

This could arise because of information asymmetries between the parties to a transaction, where one party has more information about the transaction than the other. For example, the interest rate may act as a screening device — those who are willing to pay a higher price may, on average, be riskier agents (that is, they have a higher probability of default). As the interest rate rises, the average riskiness of those who borrow increases, possibly lowering the lender's profits (Stiglitz and Weiss 1981).

EFIC has submitted that Stiglitz and Weiss (1981) made the point that 'credit rationing exists and is a market failure' (sub. DR90, p. 85). However, Stiglitz and Weiss further stated that rationing is not always present:

> It is not our argument that credit rationing will always characterise capital markets, but rather that it may occur under not implausible assumptions concerning borrower and lender behaviour. (1981, p. 394)

Considerations of export credit and insurance aside, this raises the broader point that the presence of a market failure should not simply be assumed. If intervention is to be welfare-enhancing, there should be clear evidence of the existence of a market failure.

The Commission has not found any compelling evidence of credit rationing relevant to the export credit market for Australian exporters, nor has any been provided by EFIC. The empirical study cited by EFIC in its submission (Minetti and Zhu 2011), had significant methodological flaws,[5] was related to Italian manufacturers, not Australian exporters, found only limited evidence of credit rationing, and did not

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[5] The paper inferred the outcome of credit rationing from firms' responses to two survey questions:

(i) In 2000, would the firm have liked to obtain more credit at the market interest rate?

(ii) In 2000, did the firm demand more credit than it actually obtained?

It did not test the reasons for these outcomes, which could include that credit was available at a higher price or on different terms for valid commercial reasons. Indeed, the paper considered that credit being offered at a higher than requested price was an example of 'weak credit rationing'.

offer policy-relevant conclusions. Stiglitz and Weiss (1981) themselves do not mention what role government might play, or ought to play, in addressing credit rationing.

The case for government intervention to address information asymmetry

EFIC argued:

> … numerous profitable and welfare-enhancing export transactions are left 'unserved' by the private sector because of market failures such as credit rationing [and] artificially scarce information … (sub. DR90, p. 15)

However, there are qualifiers on the case for government intervention to address adverse selection and moral hazard. First, the fact that banks or insurance companies do not have full information regarding their clients' risk is not necessarily inefficient. Acquiring and assessing information is not costless, and these costs need to be considered when deciding whether to undertake a transaction. Banks and insurance companies consider the costs of screening applicants in deciding whether it is commercially viable to enter into the transaction. As Demsetz noted:

> The moral hazard problem is no different than the problem posed by any cost … Payment through insurance premiums for the moral hazard cost imposed on insurance sellers brings in to play the usual price mechanism for economizing. The fact that not everything is insured is irrelevant to the question of efficiency. The absence of insurance, especially when moral hazard is important, merely is evidence of the unwillingness to shift all risk to others at premium levels that cover the cost imposed on sellers of insurance by these moral hazards. (1969, pp. 7-8)

Second, the information asymmetries need to be significant enough to materially affect the supply of export finance and insurance. Although the theory behind credit rationing is well developed, there is limited empirical evidence of its presence in particular markets. To justify the policy focus on export finance and insurance on these grounds, it needs to be demonstrated that this market is more vulnerable to information asymmetry problems than finance and insurance markets more generally.

Third, there is also a need to demonstrate that governments have a clear advantage over the private sector in resolving the information asymmetry problems. Finally, even if the government has some advantages over private sector providers, the intervention needs to target the problem at its source. In this case, the problem is not the outcome of credit rationing, but the information asymmetries that may have given rise to it. The intervention needs to be the minimum necessary to address this.

Imperfect information

When parties enter into a transaction based on incomplete or incorrect information sub-optimal outcomes may occur. EFIC noted that one of the largest impediments to providing insurance for medium- to long-term export credit is the uncertainty associated with quantifying the probability of loss in the future. EFIC argued that this difficulty could cause a bank or an insurance company to deny an export transaction that it would actually assess as commercially viable if it knew the 'true' risk (EFIC, sub. 18).

As stated previously, the fact that market participants do not have full information is not necessarily inefficient, because the process of acquiring information is not costless. Information should only be acquired up to the point where the additional benefits of having more information are equal to the additional costs of acquiring it — moving beyond this point would be inefficient. Stigler (1967) noted:

> … information costs are the cost of transportation from ignorance to omniscience, and seldom can a trader afford to take the entire trip … The acquisition of complete information would in general be as wasteful as the transportation of a house valued at \$30 000 in New York to California where it would be valued at \$30 200. (p. 291)

DFAT observed:

> The costs (borne by banks) in undertaking a risk assessment for an SME export transaction can often be quite high when compared against the return from providing finance. (sub. 19, p. 6)

It may be argued that a lack of information in the market for export finance and insurance requires the establishment of a public agency to collect additional information, or act as an intermediary between parties to a transaction (or both). As with all forms of government intervention, it is important to assess whether the economy-wide benefits outweigh the costs. The efficiency of an intervention of this type will be enhanced if it is targeted to where the benefits are greatest.

Are information-related failures impeding commercially viable transactions?

Problems may arise in financial markets where missing or imperfect information impedes or prevents commercially viable transactions. For instance, newly exporting SMEs may not have a credit history with a bank or have successfully fulfilled an export contract. There is a possibility that this may lead to inefficient outcomes, if the information-related market failures prevent commercially viable export transactions from proceeding.

At times, private sector providers adopt simplified decision rules to lower the costs of acquiring information to assess the riskiness of an export transaction (the transaction costs), rather than attempting to obtain complete information on every transaction (Ramskogler 2007; Ragan 2008). For example, Lean Field Developments submitted that some bonds are provided by a small number of issuers and require firms to have '(a) minimum of 3 years trading in Australia and (b) a minimum annual turnover of $20 million for those 3 years' (sub. DR78, p. 1).

Similarly, the private sector may have adopted generalised rules that restrict the provision of export finance or insurance to some countries. Several participants noted the reluctance of private sector providers to cover transactions relating to emerging or difficult markets (for example, Wellard, sub. DR34; Mono Pumps (Australia) Pty Ltd, sub. DR54). Wagner Group Holdings (sub. DR31, p. 1) argued that its lack of success in securing export finance was 'driven by financier policy that has a very Australian-centric view of the world'.

Such decision rules may be accurate on average, but may also lead to the rejection of some commercially viable transactions. The ANZ submission to this inquiry noted:

> In the Trade Finance/SME [business], where banks generally take a relatively rigid "scorecard" approach to risk and credit controls, EFIC may sometimes be able to take a more pragmatic view. This is primarily due to EFIC's ability to undertake a high level of due diligence, especially around historical performances, contract terms and management ability. They are able to consider factors other than pure financial matrices, for example, growth prospects and strategic positioning of the industry. (sub. 20, p. 6).

EFIC also noted:

> In EFIC's experience, small firms with limited credit history and no export experience represent a very high risk for credit providers. Small firms also represent a limited premium pool; that's why banks target them with homogenous credit scoring products. (sub. DR90, p. 11)

However, the ANZ previously submitted to a Parliamentary Inquiry on Access of Small and Medium Business to Finance:

> When looking at a specific lending decision we also consider the individual risk of the transaction and/or the customer. As a result, businesses with different risk profiles may receive different interest rates for similar lending. (PJCCFS 2011, sub. 14, p. 10)

Where markets are working well, there is an incentive for private sector providers of export finance and insurance to review and refine decision rules to ensure they are yielding the most profitable outcomes. There will also be an incentive for new entrants to take advantage of any uncaptured rents. The ANZ observed that it is continually reviewing its lending criteria to reflect market conditions (PJCCFS 2011, sub. 14). This is one of the reasons why it is important that private sector finance and insurance providers are subject to demands from their customers to provide innovative services under competitive terms and conditions.

Potential information-related failures are likely to be limited to newly exporting small and medium-sized enterprises

To the extent that information-related market failures exist, they are unlikely to be a significant issue for large firms or for SMEs that have a history of exporting into established export markets. Banks and insurance companies have a variety of screening and assessment mechanisms to ameliorate the problem of asymmetric or imperfect information about the risks of the transaction. These include requiring security for the loan, asking for documented proof of income and liabilities, and assessing the commercial history of the prospective client.

Large firms, particularly public companies, are required to publish financial and other information, which banks and insurance companies can access to profile a firm based on past activity. Listed companies are subject to periodic published analysis by financial industry participants and many large companies, both listed and unlisted, are periodically rated by analytical services such as Standard & Poor's. Furthermore, by virtue of their size and history, such firms have a large stock of information to draw on to support individual applications for finance or insurance.

Similarly, SMEs that have exported before and are exporting into established markets can draw on their commercial record to support their application.

In contrast, for SMEs with a limited commercial track record, information could be less accessible. The OECD noted:

> Asymmetric information is a more serious problem with respect to SMEs than for large firms, reflecting the lack of audited financial statements or other public sources of information … information may be of a subjective nature and may not be easily observed or verified by others within the same lending institution, let alone by outsiders. (2006b, p. 44)

Malhotra et al. (2006) identified a number of potential reasons for restricted availability of finance to SMEs, both for export and for domestic operation, including, among others:

- a lack of knowledge within banks on how to reach the SME market segment

- information asymmetries that increase the cost for banks to transact with SMEs. For example, some potential SME borrowers have no financial track record and are unable to provide reliable information.

In looking at the Canadian export finance and insurance market, Ragan (2008) noted that private sector providers imposed minimum volume thresholds for export insurance. The paper found that Can$5000 was typically the minimum premium, which translated to annual export sales of around Can$500 000 – 650 000.

Business SA also noted that Australian SMEs face particular problems accessing export markets:

> Most of the businesses that need assistance with exporting — from information about markets, to export stamping, to guarantees and insurance — are small and medium sized businesses that do not have the resources to investigate many of these things without external help. EFIC should target its services to small and medium sized businesses that are more likely to require guarantees and insurance. (BusinessSA, sub. 6, p. 1)

Some private sector providers stated that this is a segment of the market in which they have little interest (although this may simply reflect the fact that there are more profitable transactions elsewhere). Other participants in this inquiry noted that the impact of the rigid scorecard approach may result in some potentially commercially viable SME export transactions not proceeding.

SMEs are also less likely to possess the extent and types of assets required by banks for use as collateral, which may compound these sorts of challenges. EFIC observed:

> Collateral quality and levels are essential hurdles for any given credit in the SME sector, and price (interest rate) is used as a subsidiary rationing device. Credit is rationed towards applicants with an established credit and export performance, with newly established and growing businesses often experiencing even greater hurdles. (sub. 18, p. 4)

Some submissions argued that the SME sector requires EFIC's continued support (for example, E.W. Cox International, sub. DR69; Eco-Kinetics, sub. DR61). Whittle Consulting submitted that this was due to ongoing market conditions:

> If there is an information gap for 3 transactions, there is likely to be the same gap for 10, 20 or 103 transactions. Such a gap does not suddenly disappear after 3 transactions. If the information gap remains then EFIC has 'temporarily' assisted the SME, then left it to deal with the market. (sub. DR60, p. 3)

Does EFIC have advantages in addressing information-related market failures?

Export credit agencies often argue that they have advantages over the private sector in addressing information-related market failures, where they exist. For example, EFIC noted:

> EFIC has made a point of developing a comparative advantage in assessing many of the risks that beset exporters, e.g. country risk. EFIC's views are frequently sought on emerging and frontier markets — including by the media, conference organisers, accounting and law firms, financial institutions and exporters … EFIC is unsure why the private market hasn't taken the pains to develop such skills. But the fact is, they haven't. (sub. DR90, pp. 86-7)

To the extent that advantages exist, it does not imply that government provision of export finance and insurance is required. A more direct way of capitalising on such advantages is by disseminating the information to which EFIC has access (box 5.3). This would not extend to certain politically sensitive information provided by governments on the understanding that it will not be widely disseminated. Furthermore, governments should only collect and distribute information provided the costs of doing so do not exceed the benefits.

EFIC may also be able to help overcome information-related market failures, where they occur, through a demonstration effect for private sector providers. To achieve this, the Commission proposes that, after a facility that supports an export transaction has been approved, EFIC releases information on that facility to the market to enable private sector participants to judge, over time, the viability of servicing these and similar clients. This approach may have advantages over mere information dissemination, as the credibility of the generated information may be higher, because of the greater financial consequences to EFIC of making a mistake. An example of such a role was presented by Almondco Australia:

> We sought EFIC's help in the initial stages of our programme because of the complete lack of confidence shown by the major lending institutions. EFIC has a vital role to play in providing a short term level of backing during the early stages, until a financier becomes more comfortable. (sub. DR36, p. 1)

EFIC submitted that an ECA can engage in 'signalling' to the market where disseminating the information is not possible.

> [An ECA] can signal to the market through its cover policy on a country, information which it cannot directly supply to the market. It can also send out two other types of signals. First, by putting its money behind a project, an ECA can convince exporters that it has done a thorough and objective country risk assessment. If it simply supplied country risk assessments, it could be dismissed as too academic, or too superficial.

> Secondly, an ECA can, through its financial support, signal to a foreign buyer or government the performance-worthiness of its exporter. (sub. 18, appendix A, p. 12)

This is not, in the Commission's view, sufficient to conclude that EFIC currently performs an effective demonstration role. An effective demonstration role would reveal to financial market participants (potential buyers and sellers) the relevant information to correct the identified information-related market failure. Market participants can then use this information to make commercial decisions on whether to supply (or consume) privately provided export finance. In effect, this means that where information-related market failures are present, EFIC's role is to demonstrate to the private sector that providing export finance to newly exporting SMEs can be commercially viable and the information they need to form that view over time.

However, for EFIC to efficiently address any potential information-related market failures affecting the access of newly exporting SMEs to export finance, it must either acquire sufficient information on a possible transaction at a cost no greater than private sector providers, or charge accordingly based on the costs of acquiring that information.

EFIC claims that it has been able to lower transaction costs of dealing with SMEs by entering into partnership agreements with private sector providers (EFIC, pers. comm., 3 February 2012). For example, EFIC has partnered with the Asian Development Bank (ADB) to streamline approval processes for documentary credit guarantees. Under the arrangement, EFIC assumes up to 50 per cent of the risk when the ADB guarantees a letter of credit from an agreed list of eligible banks. EFIC argues transaction costs are lowered because it is able to draw on the ADB's risk assessment processes, networks and expertise in three Asian markets (EFIC 2011a; pers. comm., 3 February 2012).

EFIC has similar arrangements with foreign exchange providers that EFIC claims enables it to draw on the providers' due diligence processes, again lowering transaction costs of dealing with SMEs (EFIC, pers. comm., 3 February 2012).

Even if it is the case that EFIC has cost advantages over the private sector, lower transaction costs is not sufficient for EFIC to effectively undertake a demonstration role — its business model must also be consistent with that objective.

Redefining small and medium-sized enterprises

The Commission has concluded that there may be some instances of market failure arising from information-related problems in financial markets. These market failures may affect access to export finance and insurance — but are likely to be limited to newly exporting SMEs. EFIC's operations on the commercial account should be refocused to address these potential failures by demonstrating to the private sector that providing financial services to newly exporting SMEs can be commercially viable. The Commission proposes that, after a facility that supports an export transaction has been approved, EFIC releases information on that facility to the market to enable participants to make commercial decisions about providing financial services to these exporters. This will require significant changes to EFIC's mandate and operations. Recommendations are made in later chapters of this report to underpin these changes.

Importantly, EFIC's operations will need to focus solely on those firms most likely to be affected by information-related market failures — newly exporting SMEs. This raises the challenge of selecting criteria to define an SME in a manner that is suited to this policy purpose. The Commission has previously discussed the range of definitions and the difficulty in selecting a single definition for an SME. It can be one or more criteria, including the number of employees, annual turnover, capitalisation or legal status (Lattimore et al. 1998). The criteria used by a range of Australian Government and private sector agencies to define an SME are presented in chapter 2.

However, the Commission considers EFIC's criterion for its SME and Mid-Market business unit (firms with annual turnover of up to $150 million) is likely to encompass substantial firms whose challenges in securing the financial services they require are not the result of market failures that should be corrected by government intervention through EFIC. EFIC noted that segmenting its operations into two units (the other being structured trade and project finance) was for the purpose of grouping risks and clients into a practical structure for client service and risk management, rather than identifying those firms most likely to be exposed to any information-related market failures (sub. DR90).

In its draft report, the Commission suggested changing EFIC's definition of SME to a business with annual turnover of less than $25 million. However, a number of firms submitted that, while they consider themselves SMEs, they have annual turnover in excess of $25 million due to the nature of their industry:

> … ASI is a small company employing only 16 people in Australia but due to the nature of construction business the revenue can potentially be larger than the prescribed [$25 million] ceiling. This does not change the fact that ASI is a small company with limited profits and resources … (Aircraft Support Industries, sub. DR28, p. 1)
>
> LFD submits that the draft recommendation to define SME's as entities with a turnover of $25m or less is not appropriate for all industries. (Lean Field Developments, sub. DR78, p.3)

The Commission agrees that for this policy purpose a criterion based on annual turnover will not adequately capture SMEs in some industries that may be affected by information-related market failures. Accordingly, the Commission has amended its definition of SME to include an additional criterion — 'number of full-time employees'.

EFIC was also critical of the Commission's draft recommendation to restrict EFIC's support to those firms with annual turnover of less than $25 million but did not propose an alternative definition of an SME. EFIC indicated in hearings that a target range for annual turnover somewhere between $20 million and $80 million would not necessarily be a loss-making segment of the market. However, it did not provide sufficient evidence to the Commission to suggest that using this range to define an SME would capture those firms most likely affected by information-related failures in financial markets.

EFIC considered that the Commission's draft recommendation was inconsistent with other Australian Government programs designed to assist exporters, including the Export Market Development Grant scheme (EMDG). For the purposes of that scheme, an SME exporter is defined as having annual revenue (or turnover) of less than $50 million. To be eligible for support under the Enterprise Connect program, a firm's annual revenue must be between $2 million and $100 million to be considered an SME (box 2.4). EFIC's submission highlights the challenge — the definition of an SME is an arbitrary decision and there is considerable variation in the selected definitions even within Australian Government agencies and programs.

The Commission agrees with EFIC, and considers there is value in having a definition for SMEs that is consistent with other Australian Government programs designed to assist exporters. However, EFIC did not provide evidence that would lead the Commission to conclude a definition of annual turnover of $100 million or more was suited to the policy purpose proposed by the Commission for EFIC. For the reasons outlined earlier in this chapter, it is the Commission's view that smaller firms are more likely to be affected by information-related market failures than larger ones.

The Commission has revised the recommended definition of an SME to be an entity, including any related entities, that has fewer than 100 full-time equivalent employees or annual turnover of less than $50 million. This would improve the alignment of EFIC's operations with any SME related barriers to private sector finance, and accommodate firms in different industries.

RECOMMENDATION 5.1

The Minister should amend the Statement of Expectations to require EFIC to define a small and medium-sized enterprise as an entity, including any related entities, with fewer than 100 full-time equivalent employees or annual turnover of less than $50 million.

What are 'newly' exporting small and medium-sized enterprises?

As discussed earlier, the Commission considers that any information-related market failures are more likely to affect SMEs that have either had limited experience with exporting in general or are attempting to export to an emerging export market. Consequently, the Commission considers the SMEs served by EFIC in the future should satisfy at least one of these criteria.

A range of measures to align EFIC's operations with a rigorous objective that is based on information-related market failures is discussed in chapter 10.

Is EFIC destined to become a loss making entity under the Commission's proposal?

EFIC is of the view that the business model proposed in the draft report is not a commercially viable proposition (sub. DR90, p. 10). King & Wood Mallesons (sub. DR84, p. 4) agreed:

> We believe the Report's draft recommendations put EFIC's continued existence at risk. We question whether EFIC would be viable as a self-funding organisation operating under the restricted mandate the Report proposes (and we would urge that this question be fully explored before any such recommendations are finalised or implemented).

EFIC considered that smaller SMEs (annual turnover of less than $5 million) represented a credit risk, especially first time exporters without a track record, and that servicing these smaller SMEs would not be commercially viable 'both in terms of transaction costs and potential credit losses' (sub. DR90, pp.18-19).

While the Commission considers that EFIC's assistance should be limited to newly exporting SMEs, the Commission is not suggesting that EFIC be limited to those firms with *no* export experience or that it be restricted to a 'likely loss making pool of very small firms' (sub. DR90, p. 11). On the contrary, the Commission's view is that EFIC should only provide facilities on the commercial account that are commercially viable.

EFIC was also critical of the draft recommendation that EFIC's role should be reoriented to one of demonstrating that providing financial services to newly exporting SMEs can be commercially viable. EFIC noted 'The Commission does not demonstrate that this proposition is true' (sub. DR90, p. 10).

As discussed in detail in the draft report and in earlier chapters, the Commission's view is that government intervention should be targeted at solving a policy problem. In this case, the policy problem is potential failures in financial markets that affect newly exporting SMEs, and the Commission's proposed intervention is the provision of export finance through EFIC to demonstrate that servicing these SMEs can be commercially viable.

Both in the media and in submissions, there have been suggestions that EFIC needs to operate over a wide range of firm sizes in order to be commercially viable:

> Mr Armour argues that EFIC's current approach, which involves helping a broad range of companies, lets it operate at a profit and pay dividends to the federal government. He warns that a focus solely on helping small, inexperienced companies into export markets would turn EFIC into a much narrower, loss-making concern. (The Australian, 15 March 2012, p.21)

EFIC's Managing Director and CEO has stated that EFIC does not cross-subsidise from its large clients to its smaller clients (sub. DR90, p. 34; trans., p. 167). The Commission considers this is appropriate as there is no policy reason for EFIC to do so.

The reforms suggested will be a major test for EFIC to alter its cost structures and operations. However, the Commission considers that EFIC has the capability to undertake the change to a focus on SMEs as it has:

- experience in providing assistance to SMEs including those seeking support to access emerging export markets (box 5.5) and a capacity to adapt its services to the needs of the SME clientele — several SME participants commented that EFIC provided them with guarantees and bonds that could not be sourced from the private sector
- skilled staff (a point noted by several participants in this inquiry)
- well-established relationships with private sector providers (that would reduce its transaction costs in performing a demonstration role)
- a well-regarded brand.

Box 5.5 EFIC's assistance to a small to medium-sized enterprise

EFIC's assistance enabled Environment Systems & Services (ES&S) to access additional working capital to fulfil export contracts for the provision of meteorological and geotechnical equipment in Asia and the Pacific region. EFIC provided an export working capital guarantee to the company's bank, the ANZ, enabling the bank to lend the same amount to ES&S. The additional working capital helped ES&S bridge the time difference between incurring costs and receiving payment from their clients. In a submission to this inquiry, ES&S indicated that the exports concerned would not have gone ahead without EFIC's assistance.

Sources: EFIC (2012b; sub. 18).

If the private sector increasingly recognises opportunities in this segment of the market and the demand for EFIC's services gradually declines over time, this should be considered a policy success as the market failures of concern are being addressed. If on the other hand, EFIC struggles to develop a sustainable business, this would be evidence that either the market failures of concern are not extensive or they are not amenable to being addressed by the direct provision of financial services by EFIC. These matters would need to be considered in an independent review.

Information problems due to temporary disruption in the importing country

One of the situations in which intervention may be argued for is the case of 'missing markets' due to temporary information failure relating to country or sovereign risks. This may occur, for example, where the importing country experiences a severe disruption due to civil unrest, resulting in uncertainty and a temporary inability by private providers to properly calculate risk.[6]

Neither country risk (arising from the political situation in the exporting or importing country), nor sovereign risk (arising from policy changes by a foreign government), constitute types of risk related to the profile of individual exporters, even though they clearly may affect the risk of particular export transactions. This may impede commercially viable export transactions, potentially warranting EFIC's involvement. In this case, private sector providers could be encouraged to support exporter firms by the transfer of country or sovereign risk to EFIC through reinsurance services.

6 The Commission is not referring here to a disruption in global financial markets.

Despite the possibility of potential market failures during times of such disruptions, and a potential case for government intervention, Chauffour and Farole (2009) stress that government action should not come at the cost of creating significant moral hazard or subsidising those who are not in need of greater liquidity. They state that two practices in particular have been shown to be effective in reducing moral hazard and avoiding the provision of wasteful subsidies:

1. Programs should only be provided for as long as needed and should avoid crowding out commercial financial institutions — an 'exit plan' is necessary.
2. Risks should be shared rather than fully underwritten (to avoid moral hazard), and provision should be at market rates (to avoid adverse selection).

The Commission considers that, although there may be some potential rationales for public sector intervention in export finance and insurance markets during temporary market disruptions, any support provided should be carefully targeted and temporary in nature. This means having in place 'exit plans' for policy measures provided during times of market disruption. Moreover, the economy-wide benefits of any form of intervention must exceed the costs.

EFIC's involvement should be on the basis of a direction from the Minister, priced on commercial terms, limited to reinsurance to provide an incentive for private sector participation, available for a defined period and include an exit plan. These conditions would lower the risk of crowding out private sector provision when financial markets begin to re-establish. The Commission does not consider that EFIC's service offer should extend beyond newly exporting SMEs, as large companies have access to risk mitigation and management tools, including self-insurance.

FINDING 5.3

The only potential rationale for government involvement in export finance and insurance through EFIC relates to information problems affecting access to export finance and insurance by newly exporting small and medium-sized enterprises. The possible sources of those problems are:

- *inadequate information about the credit history and standing of the exporter, which could result in private sector providers employing rigid generalised rules and not forming an assessment on the merits of the transaction*
- *inadequate information about the risk associated with some emerging markets, which could result in private sector providers refusing to provide services for transactions in those markets*
- *temporarily missing markets due to severe disruption in the importing country.*

6 Pricing of export credit

Key points

- A positive accounting profit does not mean that EFIC imposes no cost on taxpayers. A net benefit to taxpayers is achieved if EFIC earns an economic profit on its portfolio.
- EFIC derives financial advantages from its exemption from competitive neutrality arrangements including some tax exemptions and a government guarantee over its financial obligations, which lowers its borrowing costs. These advantages are likely to discourage market entry by potential competitors.
- An export credit subsidy arises when an export credit agency provides financial services below their expected full economic costs, including the opportunity cost of capital. This can occur if the advantages of government ownership are passed on to clients and commercial partners as lower prices.
- The removal of EFIC's exemption from competitive neutrality arrangements will ensure that the price of EFIC's financial services reflects the expected full economic costs of provision, and provide an enhanced governance framework and discipline to operate on a commercial basis.
- EFIC's pricing techniques do not ensure the prices for its financial products are efficient — even if pricing is compliant with the OECD Arrangement on Officially Supported Export Credits.
- Not all of EFIC's facilities are priced to earn a commercial rate of return on equity as the expected income from some facilities does not offset the expected full economic costs of provision. These facilities are effectively being subsidised in advance by taxpayers.
- The beneficiaries of any subsidy are likely to extend beyond EFIC's clients and may include private sector providers, other export credit agencies, and the buyer of the exports.
- An independent review of EFIC's process in allocating a risk score to each facility should be undertaken to help ensure EFIC prices risk appropriately.

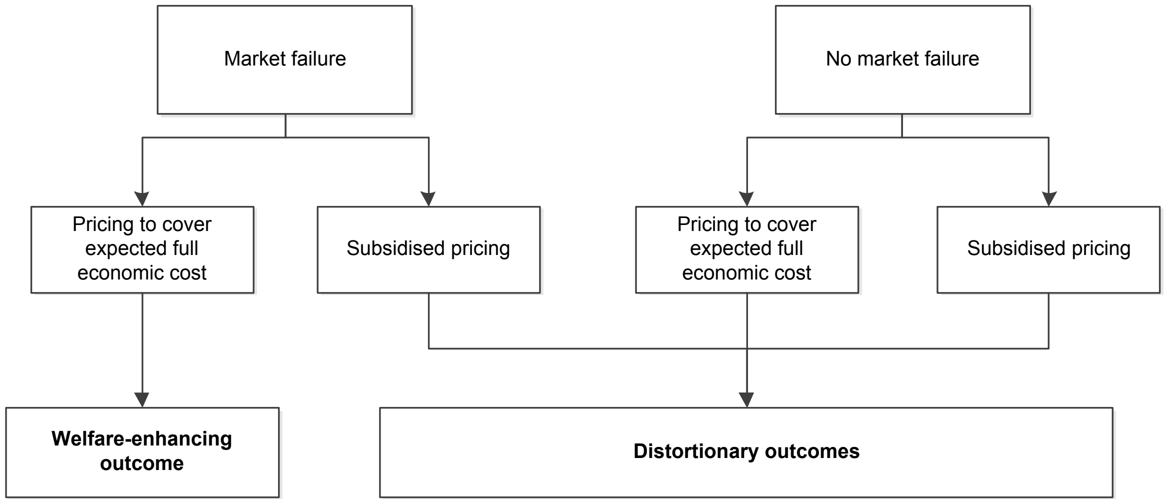
The previous chapter examined the rationales for government intervention in export credit. Even if a market failure rationale for government intervention in the form of an export credit agency (ECA) can be established, economic distortions will occur unless the price for financial services is set efficiently.

To the extent that an ECA provides financial services at a price below the expected full economic costs of provision, it can be regarded as providing a government subsidy. This chapter examines whether EFIC's pricing techniques lead to efficient prices or if EFIC provides a subsidy.

Two possible pricing outcomes are illustrated in the middle tier of figure 6.1. When there is a market failure, welfare is enhanced if the ECA prices financial services at a level that reflects their expected full economic cost.

In the absence of market failure, for an ECA to provide finance for a project (or export transaction) the price it charges must be below the market clearing price that private sector providers would have offered. This creates distortions in markets. As discussed in chapter 7, the distortion could constitute the ECA being a catalyst for projects that are unable to attract private sector support and cause resources to be misallocated within the economy. It could also result in the ECA supporting projects that would have proceeded without its involvement. If the latter occurs, the ECA may crowd out other providers of export finance and insurance, other sources of finance available to EFIC's client, or other firms competing with the assisted firm.

Figure 6.1 **Economic outcomes from ECA pricing**



The distortionary effects arising from EFIC's participation in financial markets are discussed in more detail in chapter 7. A discussion of EFIC's financial performance, including an analysis of its overall returns and cost structure is undertaken in chapter 8.

6.1 What is a subsidy and how could it arise?

An ECA reports an accounting profit when net income (revenue less expenses) is positive. A positive accounting profit does not always mean that an ECA imposes no cost on taxpayers. This is achieved when the ECA earns an economic profit on its portfolio. At a transaction level, this means the income generated from a facility must exceed all of its economic costs, including any taxes, plus the opportunity cost of risk-weighted capital. The opportunity cost of capital reflects the benefits forgone by taxpayers from having their funds utilised by an ECA compared to other public sector programs (Boyd 1982).

The capital resources EFIC uses to provide export finance and insurance products have opportunity costs. As EFIC is wholly owned by the Australian Government, these opportunity costs are borne by taxpayer. There may be a higher return (and lower risks) to taxpayers from having those funds invested elsewhere. The difference between the return earned by EFIC and returns that could be earned in alternative activities represents the hidden cost of EFIC's operations on the commercial account (CA). If such a cost exists, EFIC can be regarded as providing a subsidy.

Empirical research has shown that many ECAs have provided subsidies in the past. Appendix B contains a review of the literature.

There are two sources of potential subsidisation from EFIC's operations:

1. EFIC's government ownership leads to lower borrowing costs and tax exemptions compared to private sector providers. This could allow EFIC to pass on the benefits of these lower costs to its clients and private sector partners as lower prices and still earn an accounting profit.
2. Alternatively, EFIC could be offering services at a price that does not reflect the expected full costs of provision, given their risk. In this case, although EFIC could still earn a positive return (an accounting profit), it would be less than what it would earn if the price of its facilities fully accounted for their risk and an appropriate rate of return on capital.

EFIC's exemption from competitive neutrality arrangements

EFIC's exemption from competitive neutrality (CN) arrangements may enable EFIC to provide services on more favourable terms than the private sector (box 6.1). An exemption from CN arrangements means EFIC is exempt from paying income tax and does not pay for its government guarantee. Furthermore, it is not required to earn a particular rate of return.

The exemption from CN arrangements lowers EFIC's cost of providing its financial products, including borrowing costs, that are largely determined by the riskiness of the borrower. Standard & Poor's credit rating for EFIC is based on the statutory government guarantee (S&P 2010). EFIC is rated AAA — the same as the Australian Government. In comparison, Standard & Poor's has assigned an AA- rating to the largest four banks in Australia (CBA, NAB, ANZ and Westpac). This means the government guarantee enables EFIC to borrow funds at a lower cost than its potential competitors — commercial banks and other financial institutions.[1]

Box 6.1 **Competitive neutrality**

Competitive neutrality is an arrangement that aims to promote efficient competition between public and private businesses. The Australian Government's approach is set out in its *Competitive Neutrality Policy Statement*:

> Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership. (Australian Government 1996, p. 4)

The policy recognises that there are a number of advantages and disadvantages of government ownership but does not seek to ameliorate all of these. Instead, it focuses on those competitive advantages enjoyed by government businesses that are widespread and relatively easy to observe and correct, including:

- exemptions from various taxes (taxation neutrality)
- access to borrowings at concessional interest rates (debt neutrality)
- exemptions from complying with regulatory arrangements imposed on private sector competitors (regulatory neutrality)
- other benefits associated with not having to achieve a commercial rate of return.

Competitive neutrality policy applies to significant government businesses, but not to non-profit, non-business activities.

Source: Australian Government (1996).

EFIC's exemption from CN arrangements is based on the premise that it operates in the market gap and does not compete with the private sector (chapter 2). EFIC is notionally subject to some discipline on its ability to compete on favourable terms through the Minister's Statement of Expectations (SoE). The SoE stipulates that EFIC is 'not to undercut the private sector' (Emerson 2011, p. 2).

[1] The spread on AA and A rated corporate bonds over bonds issued by the Australian Government was 198 and 263 basis points, respectively in April 2012 (RBA 2012a). That is, the extra yield investors demand to own bonds issued by AA or A rated corporate entities instead of the Government is about 2.0 or 2.6 percentage points per annum, respectively.

EFIC stated that:

> EFIC provides funding to clients at or above market pricing to reflect risk and subject to terms and conditions that are comparable to commercial banks. (sub. 18, appendix A, p. 27)

EFIC's exemption from CN arrangements does not necessarily mean that EFIC prices at an inefficient level. However, it does lower EFIC's costs compared to private sector providers and could enable it to provide subsidised finance and insurance while still generating an accounting profit. This may discourage market entry by potential competitors.

FINDING 6.1

EFIC does not pay income tax, is not required to earn a particular rate of return on equity and the Export Finance and Insurance Corporation Act 1991 provides for its liabilities to be explicitly guaranteed by the Commonwealth. This lowers its borrowing costs relative to private sector providers, giving it a commercial advantage that may discourage market entry by potential competitors.

Removing EFIC's exemption from competitive neutrality arrangements

The Commission's assessment is that there may be some instances of market failure that may warrant government provision of export finance through EFIC (chapter 5). Accordingly, the Commission has recommended that EFIC's operations be confined to those areas where there may be market failures — in which case there are no competitors or competitors are under-providing. The removal of EFIC's exemption from CN arrangements would provide an improved governance framework and allow EFIC to transparently demonstrate that providing export finance to newly exporting small and medium-sized enterprises (SMEs) can be commercially viable.

Where governments direct their businesses to undertake non-commercial activities (for example, some transactions on the national interest account (NIA)), the business can still adopt a commercial focus to its operations by being fully and transparently funded for the non-commercial activity through a community service obligation (CSO) payment.

Australian governments have generally based their definitions of CSOs on the formulation proposed by the Steering Committee on National Performance Monitoring of Government Trading Enterprises:

> A Community Service Obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other

businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices. (SCNPMGTE 1994, p. xi)

As discussed in chapter 2, EFIC is reimbursed by the Australian Government for losses on NIA transactions and returns revenue from NIA transactions to the Government. EFIC also charges a fee for managing the NIA. The payment for losses represents a CSO payment to EFIC and its charging of a management fee provides further transparency of the cost to government of transactions on the NIA.

The Australian Government uses a business test to determine whether government businesses enterprises may be subject to CN arrangements (DOFA 2004) (box 6.2).

The benefits of applying competitive neutrality arrangements to EFIC

The Commission anticipates that the benefits from the application of CN arrangements to EFIC include:

- improved transparency of EFIC's performance as the costs to government from the provision of the statutory guarantee and forgone tax revenue will be returned to government rather than reported by EFIC as an accounting profit
- assurance that EFIC is not operating at an advantage to its private sector counterparts or crowding them out
- a more credible demonstration effect as private sector providers will have more confidence that the provision of export finance to newly exporting SMEs can be commercially viable without the advantages of government ownership (discussed further in chapter 10)
- improved commercial discipline for EFIC to maximise value for the shareholder through the requirement for it to earn an appropriately benchmarked rate of return on equity. However, unless all aspects of CN arrangements are applied, the requirement to earn an appropriately benchmarked rate of return could instead provide an incentive for EFIC to use more resources in delivering its financial services than that of a private sector provider
- providing commercial discipline to EFIC's treasury function as it will have an incentive to hold capital having regard to its cost
- ensuring that EFIC takes into account all costs when pursuing its objective of minimising borrowing costs.

Box 6.2 **Using the business test to confirm application of competitive neutrality arrangements**

There are two questions that determine the applicability of competitive neutrality (CN) arrangements to a government agency:

- Is a business being conducted?
- Is that business significant?

For the purpose of CN arrangements, a business activity is defined as one where:

- There is user charging.
- There is an actual or potential competitor (that is, users are not restricted by law or policy from choosing alternative sources of supply).
- Managers of the activity have a degree of independence in relation to the production or supply of the good or service and the price at which it is provided.

EFIC's activities on the commercial account appear to pass the business test:

- The Statement of Expectations requires that 'EFIC's Commercial Account operations are to be conducted on a commercial basis, obtaining a return reflecting risks, and National Interest Account (NIA) operations should normally be conducted on this basis' (Emerson 2011, p. 2). EFIC also charges a fee to the Government for managing the NIA.
- There is no law or government policy that restricts users from choosing alternative sources of supply and there are no legal or policy barriers to the Australian Government choosing alternative sources of supply.
- EFIC's management has independence to set prices and the level of production.

Although NIA transactions are subject to user charging, the Minister must approve, or direct, transactions in the national interest. Therefore NIA activity appears to fail the business test on the grounds of a lack of independence in relation to the production or supply of the good or service.

Business activities are considered significant if they are undertaken by a body subject to the *Commonwealth Authorities and Companies Act 1997* with a commercial turnover of at least $10 million per year (DOFA 2004). EFIC's profit in 2010-11 was $30.2 million and EFIC's turnover will be higher than profit. The benefits from applying CN arrangements must exceed the costs, which is likely to be the case:

> Costs may include changes to accounting systems, asset valuations, reviews of activities and general administration. The AGCNCO [Australian Government Competitive Neutrality Complaints Office] has recognised that the costs of applying CN principles are generally not significant and build naturally on agencies' existing costing systems. Consequently, very few businesses that pass the business test will be able to demonstrate that the costs outweigh the benefits (DOFA 2004, p. 14).

Sources: DOFA (2004); Emerson (2011).

EFIC raised issues in relation to applying CN arrangements to its business (sub. 18; sub. DR90) including:

- the tax treatment of financial instruments and borrowings
- implications for cash flow arising from tax-equivalent payments
- potential distortions where transactions are shared between the CA and NIA.

The Commission considers that any administrative issues relating to the implementation of CN arrangements would not be significant. As noted in box 6.2 the Australian Government Competitive Neutrality Complaints Office has stated that the costs of applying CN arrangements to government agencies are generally not significant (DOFA 2004) and the Commission is not aware of any complaints regarding implementation of CN arrangements by other government agencies.

Pricing does not reflect expected full economic costs

EFIC would be providing subsidised finance and insurance if it offers finance and insurance on terms that do not cover the expected full economic cost of provision. These costs include costs associated with tailored terms and conditions such as flexible timing of repayments. The OECD illustrates the consequence of not covering these costs with the example of a loan:

> The consequence may be that an importer receives a loan at an interest rate below the normal market rate, for a length of time which exceeds what the market would offer or a repayment schedule which is abnormal in timing, yet not face a fee which is adequate to offset these special conditions. In this case, the total costs for financing the purchase of that exporter's goods would be lower than would otherwise occur, so the programme would effectively subsidise the importer. (2000, p. 8)

The loan in the example above can still generate an accounting profit for the ECA, but to the extent that the price charged did not cover the expected full costs of provision then this reflects a subsidy that benefits the importer.

Dahl et al. (1995) estimated that there was an implicit subsidy for export credit guarantees because they were under-priced and that this can be expected when the goal of a government or ECA is to enhance exports:

> … governments are not charging an actuarially fair rate for credit guarantees and in fact an implicit subsidy would be embedded in exports in this case. This is not surprising. In fact, Funatsu, who examined extending insurance guarantees for Eximbank loans, indicated that underpricing or charging very low premiums for insurance coverage may be optimal behaviour if the objective is to maximize exports. (Dahl et al. 1995, p. 25)

6.2 How does EFIC price its products?

The Minister's SoE provides guidance on EFIC's pricing:

> EFIC's pricing is not to undercut the private sector when private support is present, nor undercut pricing for comparable risks when private support is absent. By charging a premium for the additional risk or quality of service it is providing, EFIC would also be encouraging the private sector to fill the gap. (Emerson 2011, p. 2)

Consistent with this expectation, EFIC has stated that it has four aims when pricing its financial products. These are to:

- achieve an appropriate return for risk
- offer pricing that will encourage a borrower to seek private market support
- achieve a return sufficient to attract private market risk-sharing partners
- encourage the borrower to refinance the transaction. (EFIC, sub. 18, p. 11)

The price for EFIC's products can include a number of components depending on the facility and the specific transaction (box 6.3).

Box 6.3 EFIC fees and charges

Depending on the type of product and individual characteristics of a transaction, the price for EFIC's products may include the following components:

- establishment fee — a fee for the cost of establishing the facility. This is typically a percentage of the facility amount
- commitment fee — a charge for the undrawn portion of a facility or for holding a credit line for the borrower
- interest rate — the price of credit. This may include a reference rate such as LIBOR (London Interbank Offered Rate) plus a margin to compensate for credit and liquidity risk
- guarantee fee — a fee for the credit risk of a guarantee. It may comprise either an up-front fee or an interest rate for the amount of the guarantee
- insurance premium — a payment for insurance cover provided over a specified period
- stand-by fee — a payment for the difference between the nominated cover of a political risk insurance policy and the maximum limit of the insurance policy
- bond premium — a payment for the provision of a bond.

Source: EFIC (pers. comm., 16 January 2012).

EFIC has stated that it uses a number of different techniques to price its products, including reference to the OECD Arrangement on Officially Supported Export Credits (the OECD Arrangement), an in-house pricing model, market data, EFIC's own assessment of the possible impact of future events, and accepting the pricing of other financial service providers and ECAs in risk sharing arrangements (EFIC, sub. 18; sub. DR90) (table 6.1).

The Commission has examined these pricing techniques and considers they are not sufficient to ensure that EFIC sets the price for its financial services at an efficient level.

Table 6.1 **EFIC's pricing techniques**

Product	*Pricing approach*
Buyer finance/export finance guarantee	OECD benchmark
Bonds	Based on market information
Export working capital guarantee	Internal policy — an annual percentage of the value of the guarantee
Producer offset loan	Internal policy — an annual percentage of amount of the loan
Foreign exchange guarantee	Revenue sharing — a percentage of revenue collected by the foreign exchange specialist
Asian Development Bank risk participation agreement	Revenue sharing
Headway[a] (working capital guarantee)	Internal policy — an annual percentage of the value of the guarantee
Documentary credit guarantee	Based on market information
Risk participation agreement	Based on market information
Structured trade and project finance (loans and guarantees)	Based on market information

[a] EFIC's headway working capital guarantee was discontinued in December 2011.

Sources: EFIC (pers. comm., 25 October 2011; 9 November 2011).

The OECD Arrangement on Officially Supported Export Credits

The OECD Arrangement outlines minimum prices and maximum terms and conditions for official export credits. It aims to encourage competitive trade on the basis of price and quality of the financial product rather than on the basis of government subsidised finance and insurance. Although the OECD Arrangement is a 'gentlemen's agreement' and not binding on OECD members, compliance with the OECD Arrangement is a specific requirement of the SoE.

The conditions for compliant transactions under the OECD Arrangement include:

- official support is to be limited to 85 per cent of the export contract value
- maximum repayment terms are five years for high income OECD contract destination countries and 10 years for all other countries
- the principal is to be repaid evenly over the life of a loan
- minimum premium rates for credit risk for transactions with counterparties in non-OECD countries (designed to recover long-term operating costs and losses)
- premium rates for transactions with counterparties in OECD countries are to be consistent with market rates (OECD 2011a).

Competitive behaviour among ECAs is still reported although the OECD Arrangement is intended to underline minimum prices and maximum terms and conditions and prevent a 'race to the bottom' (box 6.4).

Box 6.4 **Does the OECD Arrangement prevent a race to the bottom?**

In its 2010 Competitiveness Report, the Export-Import Bank of the United States (Ex-Im Bank) forecast that two-thirds of export finance and insurance by export credit agencies (ECAs) would occur outside the OECD Arrangement by 2011 (up from approximately one-fifth in 2001). The Ex-Im Bank considered that this would be the result of expansion by non-OECD ECAs and developments in OECD ECAs' products. The following examples highlight the limitations of the OECD Arrangement in preventing competition between governments on the terms of export credits.

Market windows

Market windows are government-owned agencies or programs where it is claimed finance is provided on market terms but agencies or programs benefit from government ownership through lower borrowing costs, tax exemptions and low or no dividends. The OECD Arrangement only applies to 'official support' and some participants to the OECD Arrangement have argued that lending at rates equal to or higher than their borrowing costs reflects a market outcome and not official support, regardless of whether the rates are below those allowed by the OECD Arrangement. Ex-Im Bank has identified the ECAs of Canada, Germany, Italy and Belgium as market window providers. According to the Ex-Im Bank, there is anecdotal evidence that market window financing has been instrumental in purchase decisions and it 'can pose a competitive threat in the export credit world' (Ex-Im Bank 2011b, p. 99).

(Continued next page)

Box 6.4 (continued)

Untied lending support

Untied loans are provided by some ECAs for strategic reasons and are not linked to, or conditional on, exports from the ECA's country and as such are not covered by the OECD Arrangement. Untied loans are commonly provided by ECAs to secure resources such as energy and raw materials. The Ex-Im Bank considers untied lending to be indirectly linked to exports and estimates that the volume of untied lending by G7 countries has risen from $3–4 billion a year in 2005-06 to more than $30 billion in 2009-10.

Foreign direct investment support

Foreign direct investment support can include loans, guarantees and insurance provided in support of investment in overseas countries and is not subject to the OECD Arrangement. Ex-Im Bank has identified the policies of Japan and Italy as potentially linking investment support to exports but notes that there are no quantifiable data to indicate the volume of this activity.

Matching non-compliant pricing

Non-OECD ECAs are not obliged to comply with the OECD Arrangement. The Ex-Im Bank monitors the performance of non-OECD countries with significant ECA activities including China, Brazil and India. The Ex-Im Bank has only identified China as consistently operating outside the OECD Arrangement. Examples include:

- In 2010 the Ex-Im Bank made the decision to match the sub-OECD terms offered by the Export-Import Bank of China on finance for the Pakistan Government to purchase 150 US-made locomotives.
- In 2011 the China Development Bank offered buyer finance to Brazilian telephone company Tele Norte Leste Participacoes SA (TNLP3) to purchase equipment from a Chinese exporter. Terms included an interest rate 2 percentage points below the average market rate for Brazilian companies. TPLNP3 was quoted in a media report indicating the attractive finance provided by the China Development Bank was critical in the company's decision to purchase Chinese equipment over competitors' equipment.

Sources: Ex-Im Bank (2011b); Sudeep (2011); Bloomberg (2011).

Limitations to the effectiveness of the OECD Arrangement

Some limitations of the OECD Arrangement include:

- only OECD ECAs are covered

- it does not cover financial products of less than two years maturity, agricultural and military goods, untied support to secure energy and raw materials, and domestic projects
- more generous arrangements for specific industries such as shipping and aircraft
- the ability to negotiate more generous terms and conditions following notification to other OECD Arrangement members. For example, the OECD Arrangement allows the provision of finance on more relaxed terms where it can be shown there is 'an imbalance in the timing of the funds available to the obligor and the debt service profile available under an equal, semi-annual repayment schedule' (OECD 2011a, p. 43)
- it is not a binding agreement.

Further, minimum terms and conditions are not sufficient to ensure the price of financial services offered by the ECA reflect their expected full cost of provision.

EFIC has identified aggressive pricing by other ECAs as a key risk in its 2011-12 corporate plan and has stated that the activity of ECAs may undermine its ability to price its products to reflect risk:

> A substantial part of EFIC's role is delivering services which the private sector would not generally undertake on the basis of risk, inadequate commercial returns or insufficient capacity. This may arise because of the high costs involved, or because of pricing constraints; such as the need to match the prices offered by overseas export credit agencies, precluding pricing to fully reflect risk. (EFIC 2011c, p. 51)

EFIC also stated:

> EFIC is a relatively small ECA operating at the commercial end of the spectrum of ECAs internationally. ECAs are significant players in export credit markets and other ECAs including those outside the OECD Consensus, are growing and becoming more active in Australia and in the region. (sub. 18, p. 3)

EFIC's credit manual states that, at times, terms outside the OECD Arrangement may be considered if required to match terms offered by an ECA from a non-OECD country. However, matching the terms and conditions offered by other ECAs that are more generous than those of private providers could generate a subsidy to EFIC's clients and commercial partners.

The Commission is not aware of any instance in which EFIC has entered into a facility outside the terms and conditions agreed in the OECD Arrangement. EFIC has, however, advised the Commission that it has four loans with repayment schedules aligned to match the projected cash flows of the project (pers. comm., 26 October 2011). That is, the loans do not meet the requirement that principal be repaid evenly over the life of the loan — this is permissible if members of the OECD Arrangement are notified.

EFIC's compliance with the OECD Arrangement has not been the subject of internal audit or independent review. Establishing that export finance or insurance has been provided outside the OECD Arrangement would be difficult given the incentives for exporters and buyers to agree to favourable terms and the relationship between some private sector providers and ECAs. The auditing of EFIC's compliance with its mandate is discussed in chapter 9.

Market comparison

The SoE requires EFIC to ensure its prices do not undercut the private sector.

For large structured trade and project finance (STPF) transactions EFIC has identified a number of sources of pricing information it uses for comparable transactions, including:

- pricing by private providers in a syndicated financing transaction or where a bank is co-financing with EFIC
- recent transactions with commercial banks by prospective borrowers or in debt markets of similar tenor and amortisation profile
- the price of debt instruments previously issued by the prospective borrower, trading in secondary markets
- recent transactions by other comparable borrowers, for example, with the same credit risk or operating in the same industry (pers. comm., 9 November 2011; sub. 18, appendix A).

However, because STPF product offerings are tailored to the needs of a relatively small number of clients, benchmarks may not always be available. Each STPF facility may have a different disbursement schedule, tenor and quality of security, all of which can significantly affect the risk, and therefore the appropriate price for the product.

When considering their pricing of credit, private sector providers also factor in income from other services related to a transaction (such as management and accounting fees), in addition to the yield of the facility (S&P 2011a). The interest rate received by a private provider may not be a true reflection of the total cost of the credit.

For its Small and Medium-Sized Enterprise and Mid-Market Division, EFIC has advised the Commission that it follows the pricing of its partner banks in risk participation agreements as this reflects the market price. EFIC has also said that it uses market comparisons to price its documentary credit guarantees and bonds (pers. comm., 25 October 2011; sub. 18, appendix A).

Risk sharing arrangements

EFIC engages in risk sharing arrangements with private sector providers and other ECAs. EFIC says that under these arrangements, the share of the revenue EFIC receives is commensurate with its level of exposure. Risk sharing arrangements include:

- the documentary letter of credit guarantee arrangement EFIC has developed with the Asian Development Bank. EFIC and the Asian Development Bank share the risk and revenues from guarantees provided by the bank on documentary letters of credit issued by banks in Bangladesh, Pakistan, Sri Lanka and Vietnam (EFIC, pers. comm., 25 October 2011; 2012a)
- risk participation agreements. These have been established with a number of Australian banks in which EFIC partially guarantees the bank in the event of non-payment.

EFIC has also established reciprocal risk participation agreements with a number of other ECAs. These agreements provide a formal process for co-financing international projects that involve exporters in more than one country.

Under reciprocal risk participation agreements the principal exporter negotiates credit coverage and pricing with its country's ECA (the lead ECA). The lead ECA then arranges for support from other contributing ECAs (follower ECAs).

The lead ECA negotiates with the principal exporter according to its usual terms and cedes a proportion of the revenue to the follower ECAs based on the proportion of the risk they accept. For transactions involving other AAA-rated ECAs, the ceded amount is normally 90 per cent of the risk premium revenue for the follower ECA's share of exposure, with the other 10 per cent retained by the lead ECA to cover administrative costs (EFIC, pers. comm., 7 December 2011; 23 January 2012).

EFIC's independence in setting the price under these arrangements is limited where it is not the lead ECA. When the lead ECA sets the price, EFIC's support may be provided on a subsidised basis if the price received does not cover EFIC's expected full costs of provision.

EFIC's in-house pricing model

EFIC uses an in-house pricing model to forecast the economic profit and return on equity (also referred to as the gross rate of return on capital) for each facility. This section describes how that model is used to price its facilities and the challenges of setting prices at a level that reflects the expected full economic costs of provision.

For each facility,[2] EFIC's pricing model forecasts an economic profit or loss. This is defined as:

Economic profit = total fee income – (provision for expected loss + cost of capital + overhead costs)

Economic profit is different to accounting profit. Consider a loan that is drawn and repaid over time. An accounting profit merely indicates that the income — principal and interest payments discounted to reflect their net present value — exceed the expenses, including the initial loan amount, administrative expenses and provision for expected loss. Economic profit also accounts for the opportunity cost of holding capital.

The income and cost components are described below to show how these factors influence economic profit. The discussion uses the example of a loan facility, although the pricing model is also used for other financial products.

Fee income

EFIC, as do private sector providers, typically calculates the interest rate for loan facilities using a floating reference rate based on the Australian 90 day Bank Bill Swap rate for facilities denominated in Australian currency, or the London Interbank Offered Rate (LIBOR)[3] for facilities denominated in foreign currencies. Nominal reference rates vary depending on the currency in which the facility is issued reflecting the lower cost of borrowing in US or European currency compared to borrowing in Australian dollars. Some reference rates also have an additional interest rate premium to reflect higher funding costs.

[2] A facility is made available for each transaction that EFIC enters into. A facility includes the type of product (for example, loan or guarantee) and the terms of repayment (interest rate, frequency).

[3] LIBOR is the average interest rate at which a selection of banks on the London money market are prepared to lend to one another. LIBOR is provided in 15 maturities (ranging from overnight to 12 months) and in 10 currencies. EFIC uses LIBOR rates with 6 month maturities as floating reference rates.

The reference interest rate[4] has a 'margin' added to it. The margin is required to compensate for the risk of the facility and is applied to the drawn balance of the facility. The way it is determined is explained below.

A loan facility can also have a commitment fee applied to the undrawn component of the facility and an establishment fee (box 6.3).

Costs

There are three types of costs incurred when providing a loan:

- general provision for expected loss
- cost of capital
- overhead expenses.

Costs and fee income are discounted into present value terms using the same discount factor. Overhead expenses represent administration and other costs associated with administering the loan. The general provision for expected loss and cost of capital are described below. These costs are influenced by the credit risk of a facility.

EFIC risk score

EFIC considers the riskiness of a facility and allocates it an EFIC risk score (ERS). There are nine risk scores ranked from those with minimal risk (1) to higher risk (9). Relevant available information regarding the facility is considered when assigning an ERS (for example, the credit rating of the company seeking finance). Ultimately EFIC uses its own judgement to determine the ERS. Although different financial institutions will have different protocols and risk preferences, the assignment of risk scores to facilities is standard practice.

Each ERS corresponds to a credit rating published by credit rating agencies. For example, Standard & Poor's AAA rating (for high grade investments) corresponds with ERS 1, and CCC (extremely speculative investments) equates to ERS 7. Box 6.5 shows a mapping of credit ratings to their equivalent ERS.

Rating agencies publish corporate rates of default for each credit rating and these are used by EFIC to estimate the probability of default for a given ERS. Default

[4] The reference interest rate is determined outside of EFIC's pricing model. The pricing model only sets (or estimates) the margin. Therefore, it is implicit that the cost of borrowing is equal to the reference rate.

data are based on corporate rates of default for the past 20 years from Standard & Poor's and Moody's (EFIC, sub. DR90). An average of both indices is used. Figure 6.2 shows Standard & Poor's default rates according to credit rating and corresponding ERS.

Box 6.5 **Credit ratings and the EFIC risk rating system**

A credit rating evaluates the credit worthiness of an issuer of specific types of debt (such as bonds) issued by a government or corporation. It is a measure of the relative likelihood that a counterparty will fulfil its financial commitments. A higher credit rating indicates that a counterparty is more likely to meet its obligations (a higher investment grade) than a counterparty with a low credit rating (a lower investment grade).

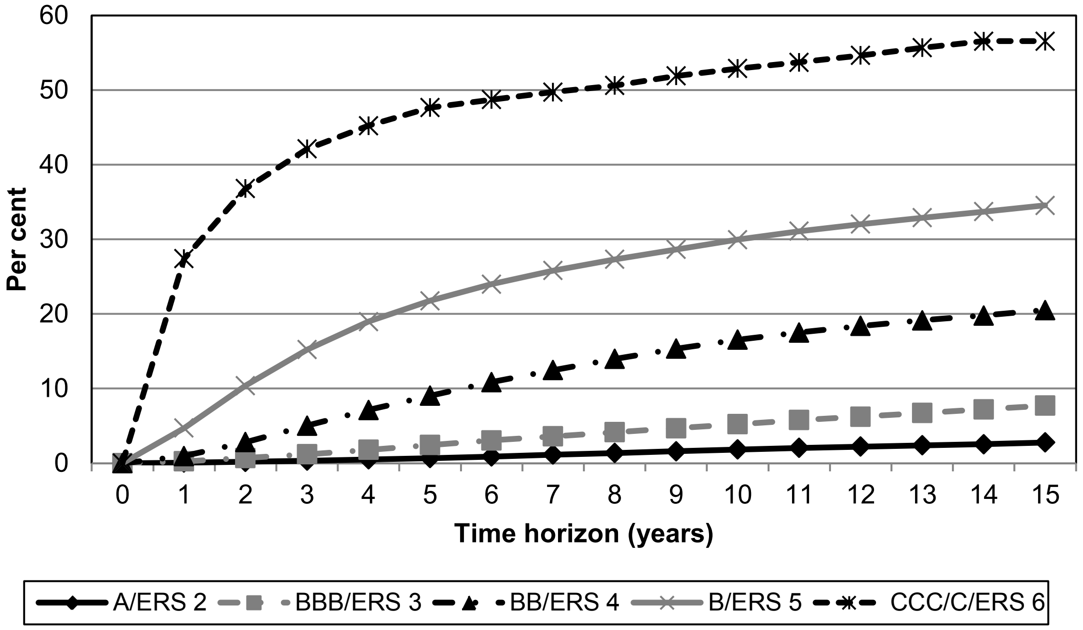
EFIC maintains a credit risk rating system that is broadly comparable to that provided by two commercial credit rating agencies, Moody's and Standard & Poor's.

A comparison of EFIC's rating system with credit ratings

Moody's	*Standard & Poor's*	*Rating agency investment grade*	*EFIC risk score*
Aaa	AAA	High grade	1
Aa1	AA+		
Aa2	AA		
Aa3	AA-		
A1	A+	Upper medium grade	2
A2	A		
A3	A-		
Baa1	BBB+	Lower medium grade	3
Baa2	BBB		
Baa3	BBB-		
Ba1	BB+	Non-investment grade Speculative	4
Ba2	BB		
Ba3	BB-		
B1	B+	Highly speculative	5
B2	B		
B3	B-		
Caa1	CCC+	Substantial risks	6
Caa2	CCC	Extremely speculative	7
Caa3	CCC-	Likely to be in default with little prospect for recovery	
Ca	CC		
C	C		
	D	In default	8,9

Sources: EFIC (2011j); Moody's (2012); S&P (2011f).

Figure 6.2 **Global corporate average cumulative default rates**
1981–2010



Source: S&P (2011b).

Provision for expected loss

The default probability for a given ERS is multiplied by the expected loss given default and the facility limit to calculate the provision for expected loss:

Provision for expected loss = default probability × expected loss given default × facility limit

The expected loss given default is set by EFIC at a constant rate — usually 45 per cent of the value of the facility (EFIC, pers. comm., 18 November 2011). The rate varies depending on whether the facility has sovereign or commercial risk and whether there is asset security (collateral). EFIC's approach here differs to that used to estimate the probability of default. EFIC claims to have an information advantage when determining an ERS (for example, information on country risk), but it does not use this knowledge to apply different loss given default rates as the ERS changes.

Cost of capital

Credit risk comprises both expected and unexpected losses. Capital is set aside for unexpected losses and general provisioning (described above) covers expected losses. The calculation to derive the amount of capital (or capital adequacy requirement) for unexpected losses is based on Australian Prudential Regulation Authority guidelines (box 8.2) and the Basel II framework (box 8.4). The capital adequacy requirement increases as the risk of an unexpected loss on the facility increases.

Once the required amount of capital for a facility is determined, the cost of capital is determined using the following formula:

Cost of capital = capital adequacy requirement × cost of capital rate

The cost of capital rate is 10 per cent for each facility in EFIC's pricing model.

Determinants of economic profit and return on equity

For a loan to have a positive economic profit, the income received from the margin (and other fee income) must more than offset its economic costs, including the cost of capital.

Terms and conditions of the facility will influence the required margin. Under the OECD Arrangement, principal and interest repayments can be paid in uneven amounts in some instances. It was noted above that some loans provided by EFIC have repayment schedules aligned to match projected cash flows of the project. Other features of EFIC's loans include:

- drawdown — instalments of a total facility amount can be drawn down at the start of the term of the facility. This delays the time at which the total principal amount of the facility is drawn.
- grace period — a period of time between when the facility is fully drawn down and when principal repayments commence.

A 'standard' loan has semi-annual principal and interest repayments commencing immediately. Where a loan has a grace period that delays principal and interest repayments, the required margin (or fees) must be higher to compensate for the delayed timing of these repayments compared to if the loan had principal and interest repayments commencing immediately.

The costs of the facility are sensitive to various assumptions in the pricing model which also influence the required margin. These are discussed below.

Cost of capital rate

The cost of capital rate reflects the opportunity cost of the capital used to finance a transaction. It should reflect the rate of return that the government would earn if it chose to invest the capital in an alternative investment with equivalent risk.

NERA (2003) found that the Export Credits Guarantee Department (ECGD), which is the ECA in the United Kingdom, would have a cost of capital rate (or weighted average cost of capital) of 11 per cent if it was operating as an insurance company in the private sector. The required cost of capital rate may have increased since this time especially as a result of the global financial crisis.

If the cost of capital rate that EFIC applies to its facilities (10 per cent) is too low, then the cost of capital will be underestimated. The cost of capital changes in proportion to the cost of capital rate. That is, if the cost of capital rate is estimated to be 15 per cent rather than 10 per cent, then the cost of capital will increase by 50 per cent.

Sensitivity of economic profit to the EFIC risk score and the default probability

The ERS EFIC attaches to a facility and the probability of default it subsequently applies have a significant bearing on the required margin. The ERS affects both the cost of capital and the general provision for expected loss.

The cost of capital could be too low if the capital amount (provision for unexpected losses) is too low. As the ERS increases, the amount of capital to meet capital adequacy requirements will also rise.

The ERS has an even stronger impact on the general provision for expected loss. As noted above, EFIC uses the ERS to assign the probability of default to the facility. The probability of default increases at an increasing rate as the ERS increases (figure 6.2). The difference in probability of default between two assets with high risk (for example, ERS 5 and ERS 6) is much greater than for two lower risk assets (ERS 2 and ERS 3).

Consequently, the expected loss of a facility increases at a much higher rate as the ERS increases. The margin required to generate an equivalent profit also increases at an increasing rate.

Table 6.2 shows how the required margin to generate an economic profit of zero (so that income exactly offsets all costs) changes as the ERS increases. For a loan with a tenor of four years in this example, the required margin would increase by 1.2 percentage points for a facility assigned an ERS 4 instead of ERS 3. In contrast, the required margin would increase by 2.3 percentage points for a facility assigned with an ERS 5 instead of ERS 4.

Table 6.2 **Sensitivity of economic profit to ERS and tenor**
Example of $100 million loan[a]

ERS	*Tenor (years)*	*Gross margin for zero economic profit (%)*	*Expected loss ($ mil)*	*Cost of capital ($ mil)*	*Overhead ($ mil)*	*Total costs or income ($ mil)*
3	4	0.5	0.4	1.1	0.7	2.2
4	4	1.7	2.1	2.2	0.7	4.9
5	4	4.0	6.2	3.6	0.7	10.5
6	4	8.6	14.5	6.5	0.7	21.7
3	8	0.9	0.9	2.5	1.2	4.6
4	8	2.2	4.0	4.5	1.2	9.7
5	8	4.2	9.7	7.0	1.2	17.9
6	8	7.6	19.1	11.9	1.2	32.3

[a] Income is equal to total costs in all examples (economic profit is zero). All amounts are discounted into net present value. Assumptions regarding drawdown periods, grace periods, repayment frequency, sovereign obligor, country risk grade and other fee income and overhead fees were held constant in each scenario and are not reported to maintain the confidentiality of the parameters in EFIC's in-house pricing model.

Source: Productivity Commission estimates based on EFIC's pricing model (accessed 12 December, 2011).

Others have examined the sensitivity of the relationship between the efficient price at which credit is provided and the default probability. Dahl et al. (1995), for example, modelled the value of credit guarantees. They stated 'Importers with greater default risk would have larger volatilities in the value of the letter of credit and/or lower price levels' (Dahl et al. 1995, p. 12). The authors modelled the effect of lower prices (greater default risk) and found 'as the price level for the underlying asset decreases, the value of the credit guarantee increases at an increasing rate' (Dahl et al. 1995, p. 12).

EFIC uses corporate data for rates of default but these rates could be different to actual rates of default for EFIC's facilities. If the rate of default of EFIC's loans and other facilities is higher than the historical data it draws on then EFIC's margin (or other fee income) will be too low to generate an economic profit. This will result in an expected economic loss for facilities that are profitable at the margin because economic profit is very sensitive to the ERS.

The determination of credit risk and allocation of an ERS is based on judgement. Given the sensitivity of economic profit to the ERS (and therefore the potential for a subsidy to arise), EFIC should benchmark how actual rates of default for its facilities compare to their expected losses. EFIC stated its portfolio is small and volatility makes benchmarking difficult (EFIC, sub. 18), meaning a comparison could not be made robustly at an individual transaction level. However, the expectation EFIC should price its risk appropriately suggests some analysis be undertaken. If provisions for expected losses are systematically less than actual losses it indicates that EFIC is underestimating (and under-pricing) the risk of its facilities. Alternatively, EFIC may be too cautious when evaluating risk if its provisions for expected losses are more than actual losses and this will also contribute to inefficient pricing.

An independent review to determine whether the ERS assigned to a facility is appropriate at the time a facility is signed will provide assurance that EFIC is evaluating risk appropriately. This has been done for at least one other ECA. Ernst & Young carried out a 'Technical Quality Assurance Review of ECGD's credit risk model, [that] suggested that the default probabilities used … were overly prudent.' (NERA 2003, p. 21).

EFIC stated in its submission to the draft report that a similar review would be unnecessary as its financial statements for allowance for credit loss in its annual reports are verified by an external auditor and are not misstated:

> In the December 2011 review of EFIC's interim financial statements the external auditors stated, 'We have performed analytical review procedures and updated our understanding of EFIC's valuation process and methodology … Nothing has come to our attention to suggest that EFIC's fair value adjustments of loans and guarantees are materially misstated at 31 December 2011'. (sub. DR90, p. 32)

The Commission does not claim that EFIC has misstated the allowance for credit risk (which is estimated by accumulating the expected loss of each facility) in its financial statements. However, the allowance for credit risk may be revised upwards or downwards for a range of reasons, including a change in the ERS. If expected losses of facilities are systematically revised (due to changes in the ERS) then this will lead to inaccurate estimates of expected economic profit in the pricing model. Evaluating whether EFIC's allocation of an ERS to a facility is accurate over time will help ensure that EFIC is pricing risk appropriately.

RECOMMENDATION 6.1

The Minister should amend the Statement of Expectations to require EFIC to commission an independent review of the process it follows to allocate an EFIC risk score (ERS) to a facility. This review should include a comparison of the ERS of each facility at signing and at maturity to examine any changes over time. Evaluating the forecasting accuracy of expected losses compared to actual losses will help ensure that EFIC prices risk appropriately. EFIC should report the results of this review to the Minister.

In sum

This section has examined the factors affecting EFIC and the techniques it employs to price its financial services. The Commission has concluded that the current arrangements do not ensure that the prices of EFIC's products are efficient, particularly given its exemption from CN arrangements.

In particular:

- Competition from other ECAs could affect EFIC's pricing. The OECD Arrangement provides only limited protection against this.
- The risk sharing arrangements in which EFIC is not the lead ECA compromise its autonomy in setting prices and make it vulnerable to following another ECA into accepting a price that does not reflect EFIC's expected full costs of provision.
- Market comparisons may be of limited use due to the bespoke nature of EFIC's facilities and the non-comprehensive nature of the information available from the private sector.
- The in-house pricing model used by EFIC is very sensitive to assumptions, particularly the ERS assigned to the facilities.

In section 6.1 it was also shown that EFIC has cost advantages over its private sector competitors due to its exemption from CN arrangements. This exemption reduces EFIC's incentive to price its financial services efficiently. The next section evaluates whether EFIC has provided subsidised facilities.

6.3 Analysis of whether EFIC's products are priced efficiently

The Commission has used three approaches to examine whether EFIC's products are priced efficiently. It has considered client views on EFIC's pricing, conducted an analysis of EFIC's portfolio of loans and export finance guarantees, and examined EFIC's financial performance. More detail on EFIC's financial performance is presented in chapter 8.

Client views on EFIC's pricing

The Commission received several submissions from EFIC's clients commenting that its prices were similar, or higher, than those charged by private sector providers. TTG Transport Technology Pty Limited (sub. 1, p. 2) stated: 'the EFIC [working capital guarantee] is expensive and leaves all the risk with the exporter'.

Ferra Engineering Pty Ltd submitted:

> The establishment and guarantee fees place a very high burden on SME's. I think that Australian SME's will be able to benefit significantly and be more competitive if Establishment and guarantee fees are reviewed and set at a level that is more in line with global benchmarks of the developed world. (sub. 8, p. 1)

Participants made similar comments on EFIC's prices following the release of the draft report:

> For Bank Guarantees / Performance Guarantees, the private banking sector is charging commonly 1.5% to 2% whilst EFIC equivalent cost is 3% to 4%, around double. (Gasco, sub. DR82, p. 2)
>
> Another postulation [in the Draft Report] is that EFIC has priced its products below true market price. Our experience has not borne this out — recently secured performance bonds were at twice the rate we would normally secure for comparable Australian project work. (Wagner Group Holdings, sub. DR31, p. 1)
>
> EFIC prices their risks adequately, in line with market norms. (Zurich, sub. DR58, p. 1)
>
> EFIC's charges were market rate commensurate with the high quality of evaluation. (Lean Field Developments, sub. DR78, p. 3).
>
> In Austal's experience, when compared on a like-for-like basis the rates offered by EFIC are no lower than those offered by commercial banks. (Austal, sub. DR110, p. 13)

However, given EFIC is to operate in the market gap, some of its facilities are for facilities have relatively higher risk than those accepted by private sector providers. In these cases, EFIC's prices should be higher than private sector providers to compensate for higher expected losses.

In addition, because EFIC is small and enters few transactions relative to private sector providers, it may not benefit from economies of scale in operating expenses and has fewer transactions over which to spread these costs. Even if EFIC's prices are the same, or higher, than the private sector for a similar level of risk, EFIC may still be subsidising the provision of financial services. For example, EFIC's operating costs may be higher and it may not be as efficient at providing financial services as the private sector (discussed further in chapter 8).

Being a price taker does not ensure efficient outcomes

Some participants, including EFIC, asserted that EFIC is a price taker and is therefore pricing at the market rate. This was supported by a claim that EFIC's prices were at least the same, if not higher, than other private sector participants in the same project. NAB, for example, stated:

> In our experience in co-financing projects with ECAs, including EFIC, we have not found that the ECAs "crowd out" the private market through below market pricing. Rather, we have found that EFIC in particular has been quite careful to become involved in financings only where a "market gap" is apparent and to be a "price taker" in that they accept pricing already determined by the private lending syndicate. (sub. DR92, p. 3)

Similarly, WICET noted:

> The price at which the EFIC guaranteed portion of senior debt is provided to WICET is on exactly the same terms and conditions as all other senior debt lenders. This was determined as part of the extensive capital raising process for the transaction. As EFIC is providing a guarantee of a portion of senior debt, rather than directly lending, EFIC only retains a portion of that return and Sumitomo Mitsui Banking Corporation, the lender of record, earns a margin within that return.
>
> The other export credit agencies or government supported financiers earn the full market return being paid by WICET as they are providing direct funding and not guarantees to other financiers. (sub. 37, p. 5)

EFIC stated:

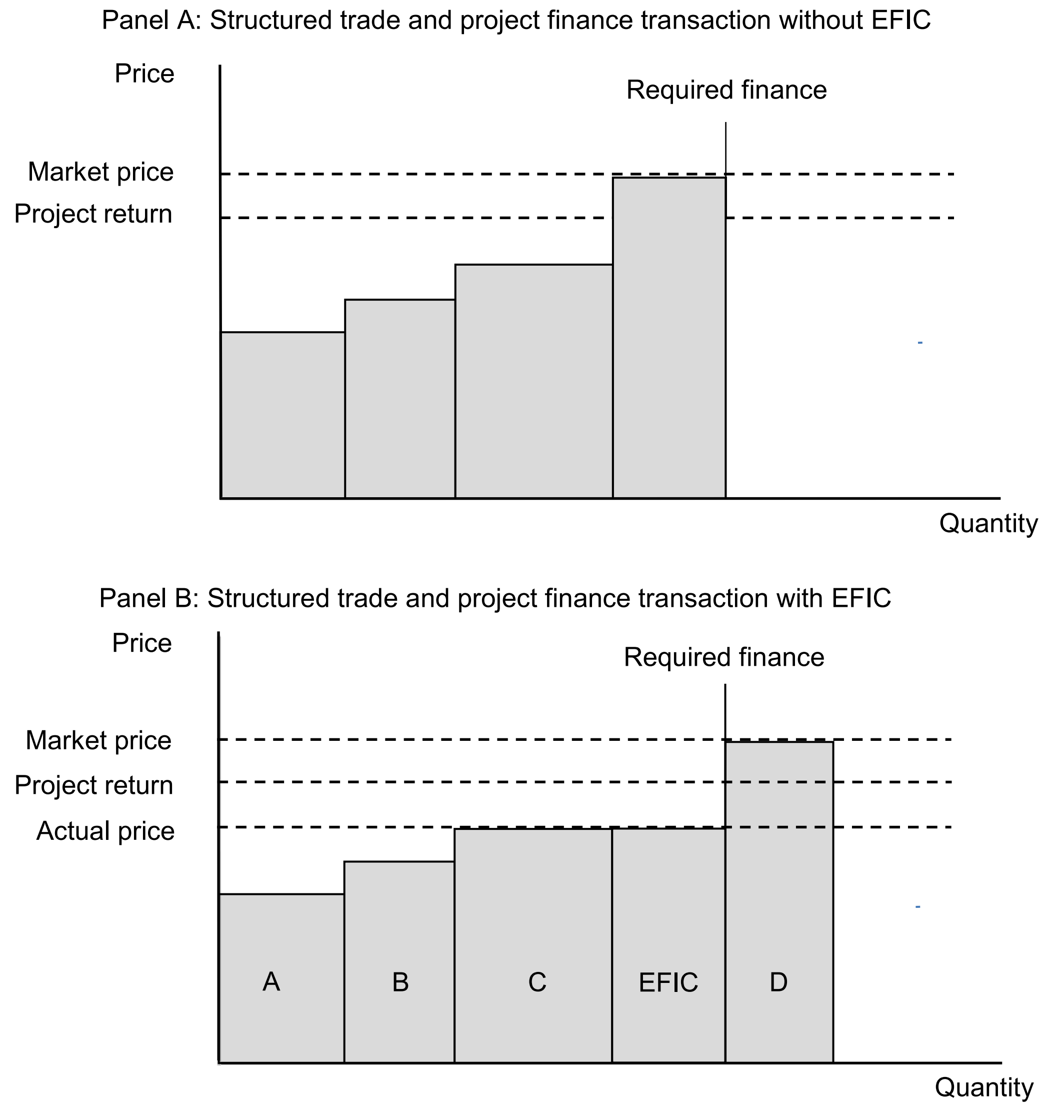
> As a price taker EFIC has consistently demonstrated the capacity to crowd in private capital (trans., p. 110).

EFIC's price can be the same, or even higher, than other providers when jointly financing a project but EFIC could still be providing finance below the market price — the price at which the market would have offered finance had EFIC not been involved.

The observed price when EFIC provides joint finance to a project can be different to the 'market' price of finance. When markets function well, the true market price is the price which would have been generated by market participants in the absence of EFIC's involvement. Figure 6.3 illustrates how the pricing of a project that is co-financed would occur with and without the support of EFIC. In panel A, the price at which finance is offered is shown for lenders A, B, C and D. The market price will be set at the price offered by the marginal lender (in this example, lender D). Without EFIC's involvement, the market price at which the marginal lender will supply finance is higher than the project's return (shown by the dark shaded area). The project cannot earn a positive return for lender D (the price of finance offered is greater than the project's return) and the project would not go ahead.

In panel B, EFIC offers finance at a price that matches other co-financiers' price, but is below what would have been offered by the marginal lender D in EFIC's absence — the true market price for the transaction. In this case EFIC sets the price at a level sufficient to generate a positive return for all financiers involved in the project and the project will proceed. However, the project would not have proceeded if the price of the required finance was determined in the market.

Figure 6.3 **Market price for finance with and without EFIC's participation**



Therefore, although participants to this inquiry, including EFIC, noted that EFIC prices at rates similar to other providers in a structured finance project, this is not a valid comparison for the purpose of ascertaining the price if EFIC was not involved in the transaction. This could mask inefficient transactions. EFIC is providing finance 'at the margin', that is, at a quantum where the private sector cannot earn a commercial return. Therefore, it is to be expected that EFIC charge a higher price than the only other (private sector) participants willing to finance the transaction.

Analysis of EFIC’s portfolio of loans and export finance guarantees

The Commission has conducted an analysis of some of EFIC’s loans and export finance guarantees to assess whether facilities are under-priced, given the risk incurred.

EFIC provided the Commission with access to information on loans and export finance guarantees written since 2005-06, and for those written prior to 2005-06, but are still outstanding (that is, those that have not reached maturity).

The information included:

- agreement and maturity dates of the loan or export finance guarantee
- exporting firm
- borrower type — private or sovereign
- contract value details
  - the facility amount
  - currency of loan
- performance of the loan (for example, whether it is being repaid, still being drawn or is high risk (impaired))
- interest rate — the reference rate and margin
- repayment frequency (for example, semi-annual, monthly instalments)
- the ERS (current, and at the time the loan was established)
- commitment and establishment fees.

In total, 13 loans were written on the CA between 2005-06 and 2010-11 (table 3.3). One of those loans was jointly financed on the CA and NIA. A small number of loans contributed to the majority of the value of all loans over the period. The resource sector and ship building industries represented the largest share of loans by value.

Estimation methods used in past studies of export credit agencies

The Commission considered past research on estimating export credit subsidies and examined the estimation methods used in studies of other ECAs (discussed further in appendix B). There are insufficient data to enable the Commission to estimate the level of subsidy for all of EFIC’s facilities using the methods cited in the literature.

Reasons for this include:

- There are few data points to draw on — three loans contributed to two-thirds of the total value of loans over the five years to 2010-11. Although there is a larger sample if a longer time period is used (up to 20 years), these data are not directly comparable because:
  - The pricing method used by EFIC has changed since the 1990s, particularly in the past few years.
  - Corporate rates of default are updated each year. It is difficult to estimate and compare what the general provision for expected loss and the cost of capital should be for transactions entered into at different points in time. The parameters are influenced by default probability rates that vary significantly, especially during periods of financial crisis. For example, the global corporate default rate for B-rated assets was 4 per cent in 2008, 10 per cent in 2009 and 1 per cent in 2010 (S&P 2011b).
- Results are sensitive to a 'market' rate of interest and there is no readily obtainable comparable rate. Research undertaken by others typically infers or estimates a market rate, which requires several assumptions to be made. Appendix B describes the limitations in accurately estimating market interest rates required for calculating the subsidy for loans.
- Results are sensitive to some data, such as grace and drawdown periods, that were not available to the Commission for all facilities.
  - A loan may have a relatively low margin because it has a shorter grace period compared to a loan with similar risk that has a higher margin.
  - Low margin income can be offset by higher income from establishment fees or commitment fees. Commitment fees are applied to the undrawn amount of a facility and the Commission did not have access to the drawdown profile.
  - Although assumptions regarding these data can be made, the accuracy of any subsidy will be influenced by these assumptions, meaning a precise estimate of the subsidy cannot be inferred.

Assessing economic profit using EFIC's in-house pricing model

EFIC's pricing model can be used to forecast the economic profit and return on equity for a facility. The return on equity and economic profit are indicators of whether a facility is commercially viable.

EFIC has not clearly indicated whether there is a minimum expected return on equity for a facility to be approved. During the public hearings, EFIC's Managing

Director and CEO indicated that, on an individual transaction basis, if a 'high-risk' transaction was expected to earn less than 8 per cent return then it would be queried as to whether it should be approved but not necessarily rejected (trans., pp. 282–3). EFIC has previously advised the Commission that the risk free rate of return (which EFIC considers to be the 10 year government bond rate) is the minimum return on equity required to approve a transaction (pers. comm., January 16, 2012).

The Commission has analysed the economic profit of some loan and export finance guarantee facilities in EFIC's portfolio using EFIC's in-house pricing model. The Commission found that some loans and export finance guarantees were not forecast to earn an economic profit. A facility that is not expected to earn an economic profit is effectively being subsidised in advance by taxpayers.

EFIC's response to the draft report

EFIC stated that the expected default probabilities in its pricing model are only useful 'to the extent that past performance is helpful in predicting the future' (sub. DR90, p. 32). Put another way, because the pricing model is a hypothetical model, the actual economic profit of a facility can be different to its expected economic profit. Thus even though a loan may have an expected (ex ante) economic loss, the actual profit would be positive, ex post, if that loan did not become impaired. Nevertheless, across a portfolio, the forecast provision for expected loss should be similar to its actual loss over time, even though the realised economic profit of an individual facility may be different to its forecast economic profit. If the pricing model is not accurate in forecasting expected loss then there is a risk of over or under-estimating the expected loss of a facility which will in turn lead to inefficient pricing (this is what recommendation 6.1 aims to determine).

EFIC also stated during the public hearings that the Commission used its own assumptions in the pricing model and disagreed that individual transactions were being subsidised (trans., p. 287). The Commission acknowledges that some assumptions were required because data on drawdown and grace periods were not provided by EFIC for all facilities, but this does not detract from the fact that some facilities were expected to be subsidised in advance. EFIC did not dispute that these data were not available to the Commission.

However, the Commission undertook sensitivity analysis on individual facilities by using a feasible range of assumptions (given the minimum guidelines under the OECD Arrangement) when data on drawdown and grace periods were not available. The Commission found that some facilities were still not expected to earn an economic profit and are therefore being subsidised in advance.

Importantly, EFIC did provide the Commission with all the required data to model the return on equity and economic profit for two recent CA facilities. Using EFIC's in-house pricing model, the Commission estimated that one of those facilities was expected to earn an economic loss of about $20 million. EFIC has confirmed that it obtained the same result[5] for this facility as the Commission (pers. comm., 16 January 2012) and has not stated that the Commission used the pricing model incorrectly to estimate the expected economic profit for this facility.

In response to the draft report, EFIC stated that the Commission should clarify the portion of EFIC's portfolio that it claims is subsidised (sub. DR90). For the reasons outlined above (and noted in the draft report) there is insufficient data to accurately quantify the subsidy rate on a portfolio basis. EFIC did not dispute this, although it did raise concerns as to how the Commission could then conclude there was a subsidy. In response, the Commission is of the view that EFIC has approved *some* facilities that were not expected to earn an economic profit based on analysis of facilities for which there was sufficient data.

A discussion of EFIC's financial performance at the portfolio level is presented in chapter 8. The Commission notes that EFIC has generated only modest accounting profits and has earned a low rate of return on equity compared to the government bond rate and other benchmarks. This is despite its exemption from competitive neutrality arrangements and consequent lower borrowing costs and tax expenses, compared to private sector providers.

When a facility is subsidised this subsidy is effectively borne by taxpayers as EFIC is owned by the Australian Government. The beneficiaries of any subsidy can extend beyond EFIC's immediate clients because, as mentioned above, EFIC enters into risk sharing arrangements with other financiers. This is discussed in more detail in chapter 7.

FINDING 6.2

Not all of EFIC's facilities are priced to earn a commercial rate of return on equity and hence, do not cover their expected full costs, including the opportunity cost of capital. These facilities are effectively being subsidised by taxpayers. The beneficiaries of these subsidies likely extend beyond EFIC's clients and may include private sector providers, other export credit agencies and the buyer of the exports.

[5] The pricing model produces slightly different results depending on the date that it is run as discount rates are regularly updated and default probabilities may have changed. EFIC acknowledged that there was a slight discrepancy between the current results and those that EFIC obtained when the facility was approved. Importantly, EFIC verified that the model forecast an economic loss of about $20 million at the time the facility was approved.

The Commission is of the view that EFIC should not have any cost advantages over private sector providers resulting from its exemption from CN arrangements. EFIC should price all of its facilities such that the expected full costs of provision are recovered. Both of these measures will ensure EFIC does not provide subsidised finance on that CA.

The Commission considers that the *Export Finance and Insurance Act 1991* (Cwlth) (EFIC Act) should be amended to ensure EFIC's activities on the CA are compliant with CN arrangements, including paying a tax-equivalent charge and a debt neutrality fee. Interim arrangements should be put in place until such time as changes to the EFIC Act are passed by Parliament. The SoE should be amended to require EFIC to publicly report that part of its revenues that relate to these pricing principles until the EFIC Act is amended.

EFIC should also be required to earn an appropriately benchmarked rate of return on equity to allow EFIC to transparently demonstrate that providing financial services to newly exporting SMEs can be commercially viable.

RECOMMENDATION 6.2

The Australian Government should amend the Export Finance and Insurance Corporation Act 1991 (EFIC Act) to ensure EFIC's activity on the commercial account complies with competitive neutrality arrangements. This will require EFIC to pay a tax-equivalent charge and a debt neutrality fee.

The Minister should amend the Statement of Expectations to:

- ***require the pricing of EFIC's commercial account facilities to reflect the expected full economic cost of provision, including the opportunity cost of capital, taxes paid by private sector participants and the benefit that EFIC obtains from the government guarantee***
- ***set an appropriately benchmarked rate of return on equity following consultation with the Treasurer and the Minister for Finance***
- ***require EFIC to identify in its annual report and corporate plan that part of its revenue that relates to not having to pay a tax-equivalent charge and debt neutrality fee, until the EFIC Act is amended to apply competitive neutrality arrangements.***

7 Economic impacts of current arrangements

Key points

- EFIC is expected to perform its functions only in circumstances where private sector providers are not able or willing to provide services for financially viable transactions and projects. This is referred to as the 'market gap' mandate.
- The market gap can cover circumstances where there is no market failure that warrants EFIC's intervention in financial markets.
  - EFIC is unnecessarily changing the allocation of resources in the economy if its involvement in financial markets is not addressing a market failure.
  - The greater the flow on or multiplier effects of EFIC's intervention, the larger the economy-wide distortion if the intervention occurs in the absence of a market failure.
- Where EFIC engages in projects and transactions that would have gone ahead without its participation, it will be crowding out a private sector provider of finance, or removing the need for companies to call on other sources of finance, including equity.
- There is no convincing evidence that there are problems relating to the provision of capital to resource-related projects in Australia, or suppliers to those projects, that require EFIC's intervention in financial markets.
- EFIC's involvement generates a benefit for a small number of clients and parties to the transaction. However, the costs are borne by others in the economy, including the direct competitors of the assisted firms and the taxpayer.
- EFIC's relationship with private sector providers of finance and insurance, exporters and other export credit agencies alters incentives to efficiently provide and consume export finance and insurance.
- Private sector providers of finance and insurance benefit from their relationship with EFIC in several ways including through the transfer of some of their risk to EFIC and achieving higher returns.
- EFIC's support may be becoming entrenched in some firms' business strategies. This includes exporting firms and, to a smaller degree, some private sector providers of financial services.

Chapter 5 examined potential rationales for maintaining an export credit agency and concluded that, with the exception of some information-related market failures affecting newly exporting small and medium-sized enterprises (SMEs), the provision of financial services through the Export Finance and Insurance Corporation (EFIC) is not warranted on market failure grounds. Chapter 6 considered how EFIC prices its financial products and concluded that some of its facilities were priced below the expected full economic cost of provision.

This chapter examines the economic impacts of EFIC's operation on the commercial account (CA) in the context of its market gap mandate, and the earlier finding that some of EFIC's transactions are subsidised. It also considers EFIC's relationship with private sector providers of finance and insurance, exporters and other export credit agencies (ECAs) to examine the effect EFIC has on their incentives to efficiently provide and consume export finance and insurance.

7.1 The market gap

EFIC's capacity to support Australian exporters on its commercial account is qualified by its market gap mandate — it is only to operate where the private sector is not able or willing to service viable Australian export transactions or overseas projects.

The purpose of the market gap mandate is to constrain EFIC's activities to parts of the market that are not served by the private sector thereby seeking to ensure it complements, rather than competes with private sector providers. The market gap mandate is the basis for EFIC's exemption from competitive neutrality arrangements (discussed in chapter 6).

EFIC noted in its submission to the draft report that efforts to give greater certainty to Government and EFIC's clients include developing criteria for the market gap (box 7.1) and the establishment of a 'portfolio risk band'. The portfolio risk band is a:

> … quantitative risk-based measure for EFIC's activities (i.e a portfolio that was too risky could result in losses, or a portfolio of too high quality might suggest EFIC's activities were intruding on the market. (sub. DR90, p. 23)

The criteria and the process EFIC uses for assessing the presence and size of the market gap are vague. It is also not clear how an indicator of risk, in isolation from knowledge of the price a private sector provider would be willing to accept to compensate for that risk, provides further guidance on the presence or otherwise of a market gap.

EFIC argued that the 'market gap recognises instances of market failure' (sub. 18, p. 9). The four rationales for government intervention claimed by EFIC in its submission to the Commission's Issues Paper were credit rationing, information, cross-border contracts and financial crises. The Commission's assessment of these rationales is discussed in chapter 5. It was also noted that, even if a market failure is present, this does not necessarily mean governments should intervene or that the most efficient form of intervention is government provision of export finance and insurance through EFIC.

Box 7.1 **EFIC's criteria for the market gap**

EFIC states that it assesses transactions on a case-by-case basis using six markers to determine whether the transaction meets the definition of 'market gap':

- risk — such as country or project specific risk
- size — whether the project's size affects commercial market participation
- term — a facility with a longer term will be more likely to be in the market gap than shorter term facilities
- industry — higher risk industries, such as developing industries, are more likely to be in the market gap
- firm size — whether the firm's size or experience creates a barrier for commercial providers, or the firm's experience heightens their perception of risk in a particular market
- private market capacity — whether current country or project limits, term constraints or lack of relevant experience affect the extent or quality of coverage provided or the consistency or reliability of private sector support.

Source: EFIC (sub. 18).

Is there a market gap?

EFIC's market gap mandate may encourage it to take on some transactions that are riskier than private sector providers are usually willing to accept given the expected returns from the transaction. For example, long-term loans are more risky to finance than short-term loans, all other things being equal. Similarly, transactions involving firms with relatively little experience in exporting may be more risky than other transactions. So too, may transactions involving firms that operate in comparatively risky industries, or that export to nations with high sovereign risk or poorly functioning legal systems.

EFIC states that two of the reasons clients seek support are credit constraints within the private sector and EFIC's ability to assist with long-term financing requirements beyond the capacity of the private market, for example, facilities with tenor of more than 10 years (sub. 18).

Should EFIC take on more risk than private sector providers?

Risk is most efficiently borne by those best able to manage it and not just those able to afford it, particularly where it comes to government providers that are not subject to the same commercial discipline and constraints that apply in the private sector.

The fact that it is difficult to secure finance and insurance for high-risk export transactions is not surprising as it reflects the nature of financial markets and the fact that capital is scarce. Exporters must pay more to secure finance or insurance for high-risk transactions than for low-risk transactions. As a result, high-risk transactions will not go ahead where the cost of financing or insuring those transactions is such that the transaction would no longer be commercially viable. This is not a market failure but an essential feature of financial markets that is consistent with prudent financial management.

Government attempts to interfere with the process of allocating capital through well-functioning markets potentially increases the number of bad loans made and may lead to inefficient market outcomes (Day and Liebowitz 1998). The examples of failed attempts by Government-run financial institutions to allocate capital to opportunities rejected by the private sector (discussed in chapter 4) lend support to this argument. Jubilee Australia observed:

> … just because a project or transaction is beyond the risk appetite of private financiers, this does not alone signal the need for government intervention in the form of official export credit, whether on the Commercial Account or the National Interest Account. In this case, rather than facilitating and encouraging Australian exports to the benefit of the wider Australian community, EFIC is being used to shift the risk for global trade and investment from private banks and companies to the public-sector, taxpayer backed export credit accounts. EFIC is, in this case, the 'lender of last resort' for Australia's riskiest export activities. (sub. 12, p. 7)

The transaction based approach to the market gap — evidence from participants

For the most part, it appears the private sector offers the same types of products as those offered by EFIC (although this does not mean they are offered in all markets, such as those with high sovereign risk) (chapter 3). This suggests that the issue may primarily be the price and other conditions on which individual transactions are not supported by the private sector. This is confirmed by EFIC's board papers that indicate the market gap is generally defined in the context of individual transactions that EFIC considers would otherwise not attract sufficient support from the private sector (discussed further in chapter 9).

Evidence from participants shows that a number of transactions in which EFIC has become involved on the basis of the market gap do not have a sound market failure basis for intervention.

Assisting the firm to meet its preferences for risk and sources of finance

Brookfield Rail obtained debt financing from a syndicate of banks to fund a \$565 million rail upgrade in Western Australia (box 7.3). Brookfield Australia's submission states:

> Brookfield Rail was required to secure additional debt financing in order for the investment program to provide the return profile required to warrant the investment of equity by its parent. (sub. DR102, p. 1)

Brookfield Australia also indicated that the construction facility was required to adhere to a framework for additional indebtedness provided under the existing syndicated loan facility. Among other conditions, the framework required that security associated with capital expenditures and increased indebtedness be provided. EFIC entered into an agreement with Brookfield Rail in 2011 to provide a US\$270 million insurance policy to meet this requirement for additional security.

In this example, it appears that the preferences of the parent company, Brookfield Asset Management, and Brookfield Rail's lenders played an important role in the requirement for EFIC participation in the transaction. Additional debt was required to meet the company's preferences for a particular investment return profile and additional security was required to meet the lender's risk preferences. The company's internal policy determined more debt was needed and, in turn, Brookfield Rail's lenders determined that insurance was needed to enable the investment to go ahead — not a failure in financial markets.

It may also be the case that the Australian Government's or EFIC's participation is explicitly cited by clients or private sector providers as a precondition for the transaction to go ahead. The ship building company Austal, for example, stated that EFIC support has often been made a precondition by clients to facilitate the sale of their vessels. This is typically the case when the commercial lender in the buyer's country is unable to fund a transaction. The submission goes on to state that commercial lenders are withdrawing from the market due to turmoil in global financial markets, a situation compounded by upheaval in European capital markets (sub. 27).

At the public hearing Austal stated that, in relation to the sale of a particular vessel:

> The sovereign nation that we're dealing with has said that they do need funding support for the transaction. They have specifically asked for Australian government support. (trans., p. 50)

As noted earlier, EFIC's participation in export transactions lowers the risk borne by other parties to the transaction. A preference for EFIC or Australian Government participation is an explicit call to shift risk from the participants in the transaction to taxpayers — and does not constitute a market failure.

EFIC's involvement in a transaction may also allow a firm's owners to avoid diluting their equity.

When asked whether it would consider finding other equity partners, Bronx International stated:

> I think that will only happen if we wanted to diversify into a different sort of business … We don't see any need really to get a lot of equity for the sort of business we're doing now … (trans., p. 209)

There are alternate sources of finance available to a firm's owners when seeking to expand their operations. Owners may have preferences for certain types of finance over others, and even preferred times at which to access sources of finance including equity; nevertheless, a reluctance to issue new equity, and thus dilute the ownership of existing shareholders, does not represent a market failure or provide grounds for support by a government agency such as EFIC.

Supporting clients because of transaction costs of switching to a private provider

In justifying the grounds for repeat business with Shark Bay Salt, EFIC commented:

> EFIC provided support because the company's Australian bank could not confirm the letters of credit due to its internal counterparty/country limits on Indonesia. The cost to the exporter of moving to another bank was prohibitive due to 'switching costs' and without switching, other banks would have little incentive to support a 'one-off' (relatively small) export transaction. (sub. DR90, pp. 80–1)

Reluctance on the part of an exporter to incur the costs of finding a bank more supportive of their business activities is not an instance of market failure. It is in the interests of an exporter to investigate alternative financial providers and the costs of switching are part of that decision. Other firms and individuals within the economy regularly make these decisions without any government involvement.

A means of overcoming prudential limits of the client's banks

Another instance illustrating that the market gap concept is not equivalent to market failure occurred in relation to a direct loan provided to Leighton Holdings announced in 2009. Of this facility, EFIC (2009a) stated:

> Growth in its Indonesian operations meant the Leighton Group needed to expand its existing mining fleet and equipment. Leighton has strong business fundamentals, but approached EFIC for assistance as it had reached its approved offshore leasing limits with its banks. (p. 25)

However, the fact that a company has reached the prudentially determined credit limit of their bank normally would not be a ground for intervention by a public agency. Financial institutions limit their exposures to risks as part of sound financial practice. As discussed throughout this chapter, there are alternative sources of finance available to businesses such as equity raising.

Supporting clients unable to secure finance because of recent financial distress

EFIC offered a bond facility in the 2011-12 financial year to Greyhound Australia for transport services in Western Australia (box 7.2). This is part of an initiative involving suppliers of goods and services that form an 'integral' part of an ultimate export (trans., pp. 117–9). In discussing this particular facility, EFIC remarked:

> … Greyhound went through some difficulties and the company was turned around and is backed by a number of banks. None of them were prepared to issue the bond, or not under the circumstances. So therefore we negotiated with Greyhound … (trans., p. 122)

This would also not provide grounds for intervention if, in this case, the banks concerned were not willing to issue the bond with less than full-cash cover due to the recent financial performance of the prospective client. Financial institutions examine the recent financial performance of prospective borrowers and unless their decisions are affected by information problems (discussed in chapter 5), the outcomes would not justify government intervention through EFIC.

Assisting clients to meet project and financing deadlines

Wiggins Island Coal Export Terminal (WICET) Pty Ltd, for example, submitted to the Commission:

> EFIC's involvement from April 2011 and final commitment in September 2011 was a critical component for WICET being able to complete the financing. WICET's mandate could have been withdrawn by the Queensland Government had Financial Close not been achieved within the State's timeframe. (sub. DR37, p. 5)

The failure by one party to the transaction to meet a commercially agreed deadline is not a market failure and would not form the basis for government assistance elsewhere in the economy. Delays in reaching financial close can be the result of private risk preferences. Delays may indicate, for example, that potential parties to the transaction regard the project's financing structure as commercially unattractive, that one of the parties requires more information before confirming their participation, or that the firm was too ambitious in its ability to meet the timeframes set by it or the government.

Box 7.2 **Should EFIC have supported Greyhound Australia?**

In 2012, EFIC provided a $5 million performance bond on behalf of Greyhound Australia (EFIC 2012f) for it to meet the terms of a $105 million contract to provide coach services for a mining operation at Wheatstone in Western Australia. The facility is one of the first under a new initiative to serve suppliers contributing to the production of exports but who themselves do not export. Under the initiative, suppliers 'must form an integral part of the overall resource export project' to be eligible for EFIC's support (EFIC ndd, p. 1). Eligible suppliers can apply to EFIC for bank guarantees, working capital support and longer-term finance.

A market gap?

The 'market gap' identified by EFIC was the unwillingness of Greyhound Australia's bankers (including ANZ which is also the company's former majority shareholder) to provide a bond with less than full-cash cover. This was despite Greyhound Australia's long history in the coach industry, its financial restructure and its other contracts to service mining operations. At public hearings EFIC stated:

> The performance bond is for six years. There is no bank in Australia that is willing to take risk on Greyhound for six years. There is just not the slightest question about it. What EFIC has done is provide that bond to Greyhound to enable it to win business. (trans., p. 129)

Greyhound Australia's inability to source a performance bond with less than full-cash cover may in part stem from its financial situation — an insolvency and turnaround advisory firm was appointed by ANZ to restructure the company in 2006 and in recent times, Greyhound Australia has undertaken a review of its business strategy.

(Continued next page)

Box 7.2 (continued)

An inability to source a financial product because of a firm's particular financial situation does not constitute a market failure. A range of alternatives may have arisen if EFIC had not provided a performance bond. For example, Greyhound Australia may either have renegotiated the terms of service, provided a bond with full-cash cover or the contract may have been awarded to another firm. In fact, EFIC's actions precluded those outcomes. It stated:

> We gave them the financial support they needed to ensure that they won that business and it couldn't go elsewhere. (trans., p. 130)

Local content?

Information provided to the Commission by EFIC indicates Greyhound Australia was the preferred tenderer over a number of Australian competing tenderers, and one with foreign ownership (EFIC pers. comm., 11 April 2012). When assessing Greyhound Australia's application for the performance bond, EFIC did not seek to confirm which firm was the next preferred tenderer. This was despite stating at public hearings: 'what is important is the Australian content component, and this is why this initiative has been started' (trans., p. 124). EFIC's focus was on Greyhound Australia's ability to proceed with the contract, and less so on whether its support for Greyhound disadvantaged local competitors.

Relationship to exports?

At public hearings, EFIC was also unable to present a clear rationale as to why coach operators servicing domestic resource projects should be eligible for assistance when other suppliers, such as cleaners and caterers, are not (trans., p. 127). In assisting Greyhound Australia, EFIC has adopted a very broad definition of exports, a precedent bringing a significant risk that it will continue to extend its activities where no market failures are present.

Market gaps *per se* do not warrant government intervention

Given the discussion above, the Commission does not consider that the market gap concept is helpful in establishing whether government intervention may be warranted. The concept of the market gap is so broad it captures transactions that have no market failure rationale for government intervention. For these reasons, the Commission considers that the market gap concept is unsound and does not ensure that EFIC's activities address a market failure.

In the context of a well-functioning financial market, there will be sound reasons why private providers do not support particular transactions. The disconnect between market failure and the market gap means that EFIC's decisions to support a transaction are not based on economic signals that would normally incentivise the provision (and consumption) of export finance and insurance. This has the consequence that EFIC is involved in transactions that unnecessarily change the allocation of resources in the economy. Assurances by prospective clients that other sources of capital have been exhausted, a client's preferences for risk or a particular business model, or a reluctance to bear the full costs of alternatives are not sufficient to determine that EFIC's involvement in a transaction or project will enhance the economic welfare of the Australian community.

FINDING 7.1

The concept of the market gap can cover circumstances where there is no market failure that would warrant government intervention through EFIC. EFIC has provided assistance on the basis of the market gap in circumstances that are not a result of market failure including:

- *a reluctance by firms to dilute the equity of existing shareholders by taking on additional equity partners as a firm expands*
- *firms exhausting other forms of debt or equity finance*
- *meeting the credit preferences of the firm's owners*
- *participants making EFIC's involvement a precondition of the transaction or project proceeding*
- *reluctance by an exporter or buyer to incur the transaction costs of finding more supportive bankers*
- *firms reaching the prudentially determined credit limits of their banks*
- *private sector providers declining to supply services because of recent financial distress of the client*
- *timeframes determined by approval processes, including government approval processes, not being met without EFIC's assistance*
- *private sector providers seeking to make a transaction or project more attractive through EFIC's participation.*

RECOMMENDATION 7.1

The Minister should remove the 'market gap' mandate from the Statement of Expectations as it lacks rigour and does not ensure that EFIC's activities generate a net benefit to the economy.

Application of EFIC's market gap mandate — domestic resource projects and large companies

Further consideration of EFIC's activities demonstrates how operating under a market gap mandate enables it to become involved in financing or supporting large projects that are not subject to market failures. This involvement distorts the allocation of resources in the economy and exposes the Commonwealth to non-trivial financial risk.

EFIC's support of large firms and resource-related projects

The provision of facilities for large firms formed a significant proportion of EFIC's 2010-11 signings (table 7.1). In addition, EFIC has recently turned its focus to financing projects located in Australia related to the export of resources. EFIC has supported corporate clients in several projects:

- EFIC provided a US$100 million export finance guarantee to the Wiggins Island coal export terminal consortium for a $3 billion project to increase coal export capacity at the Port of Gladstone (box 7.3)
- EFIC provided a US$270 million insurance policy to Brookfield Australia for the upgrade of a rail line from Morawa to Geraldton (box 7.3)
- EFIC provided a $248 million export finance guarantee to the Santos LNG project in Gladstone (box 7.7)
- EFIC recently offered a bond facility worth $5.1 million to Greyhound Australia for the provision of transport services in Western Australia (box 7.2)
- EFIC has also indicated an intention to participate in the Ichthys LNG project in northern Australia (trans., p. 144–5).

Table 7.1 **EFIC support for large corporate firms**

Commercial account, 2010-11

Underlying exporter	*Sector*	*Facility type*[a]	*Value (A$mil equiv)*
Leighton Asia (Northern)	Construction	Loan	76.7
Austal[b]	Ship building	Loan	66.8
Leighton Holdings	Construction	Bonding line	50.0
UGL Limited	Construction	Bonding line	50.0
Brookfield Australian Investments	Construction	Bonding line	48.0
Incat Tasmania	Ship building	Loan	37.5
Anglo Coal Australia	Mining	RPA	30.3
Transfield Services	Professional	Bonding line	30.0
Thornycroft Maritime & Associates	Professional	EFG	25.5
McConnell Dowell Corporation	Construction	Bonding line	25.0
Clough Groups	Construction	Bonding line	16.6

[a] EFG denotes export finance guarantee. RPA denotes risk participation agreement. [b] Loan provided by EFIC to buyer of Austal vessel.

Source: EFIC (2011a).

Box 7.3 **EFIC involvement in resource-related projects**

EFIC is participating in the financing of three resource-related projects. These include the Wiggins Island coal export terminal and the Brookfield Rail project. The third, the Gladstone LNG project, is discussed in box 7.7.

Wiggins Island coal export terminal

EFIC provided a US$100 million export finance guarantee to the $3 billion senior project finance debt facilities for the Wiggins Island coal export terminal (EFIC 2011e). Once fully operational the terminal will provide more than 80 million tonnes of additional export coal capacity through the Port of Gladstone each year (WICET nd). There are 19 financial institutions providing finance to the project, and EFIC's involvement guarantees US$100 million of debt for Sumitomo Mitsui Banking Corporation (EFIC 2011e).

Brookfield rail upgrade

In early 2011, Brookfield Rail commenced an upgrade of the rail infrastructure between Geraldton and an iron ore mine located in Karara, Western Australia. The mine is a joint venture between Gindalbie Metals and Chinese company, Ansteel. The rail infrastructure is part of the general rail system in the mid-west of Western Australia, formerly operated by the Western Australian Government.

(Continued next page)

Box 7.3 (continued)

EFIC disclosed its involvement in the upgrade in the second half of 2011.

EFIC has provided a US$270 million insurance policy to Brookfield Australia Pty Ltd for the Brookfield rail upgrade project. The purpose of the facility is to insure the credit risk on a letter of credit issued by a AA- rated bank owned by the Chinese government (EFIC, pers. comm., 12 December 2011).

More than half of the facility will be reinsured by another export credit agency.

Brookfield Rail is a wholly owned subsidiary of Brookfield Infrastructure Partners L.P., a company with extensive worldwide operations. The company's other interests include European ports, Canadian freehold timberlands and US electricity transmission (Brookfield Infrastructure Partners L.P. 2011). The parent company, Brookfield Asset Management, is listed on the Toronto and New York Stock Exchanges, and in 2007 acquired Australian construction firm Multiplex.

In the year ending 31 December 2011, Brookfield Infrastructure Partners L.P. reported a net income of US$440 million, and had more than US$13 billion in assets at 31 December 2011 (Brookfield Infrastructure Partners L.P. 2012).

Brookfield Australia Pty Ltd noted in its submission to the Commission 'there was no obligation on Brookfield Rail, regulatory or otherwise, to invest in the track upgrade unless it determined the commercial rationale warranted the investment and the assumption of associated risks' (sub. DR102, p. 1). That is, Brookfield Rail entered into the rail upgrade project based on commercial returns to the company.

The submission further noted EFIC's support was sought because 'Brookfield Rail was required to secure additional debt financing in order for the investment program to provide the return profile required to warrant the investment of equity by its parent' (sub. DR102, p. 1). EFIC's submission to the draft report noted that Brookfield Rail and its lenders were unprepared to accept the risk of a government owned Chinese bank without risk mitigation in place. Rather than EFIC's involvement being driven by a failure in financial markets, it was the company's internal policy that determined more debt was needed and, in turn, Brookfield Rail's lenders who determined that insurance was needed to enable the investment to go ahead.

Evidence on the availability of finance

Following its draft recommendation that EFIC cease to undertake this type of activity on the CA, the Commission received many submissions claiming a need for EFIC to participate in large resource projects located in Australia. One exception to the views expressed in these submissions came from the Australian Industry Group:

> We support the recommendation that EFIC should not continue to provide finance for domestic resource projects on the commercial account. Feedback from our membership indicates industries outside the mining sector, such as food processing,

> pharmaceuticals, scientific equipment, transport equipment and cosmetics for example, that require substantial funds for capital investment to lift their ability to export, struggle to obtain funding. (sub. DR98, pp. 1-2)

In contrast, several participants noted the long pipeline of resource and infrastructure projects in Australia and suggested that projected capital expenditure is more than the private sector is able to service. For example, EFIC stated that one product currently underprovided by the private sector is:

> Project financing for large export infrastructure projects due to the extremely large debt requirements and the current withdrawal of international banks, particularly European banks. (sub. 18, appendix A, p. 18)

A number of EFIC's clients submitted to this inquiry that following the global financial crisis (GFC), there were shortfalls in private market capacity for project finance.

For example, Santos argued:

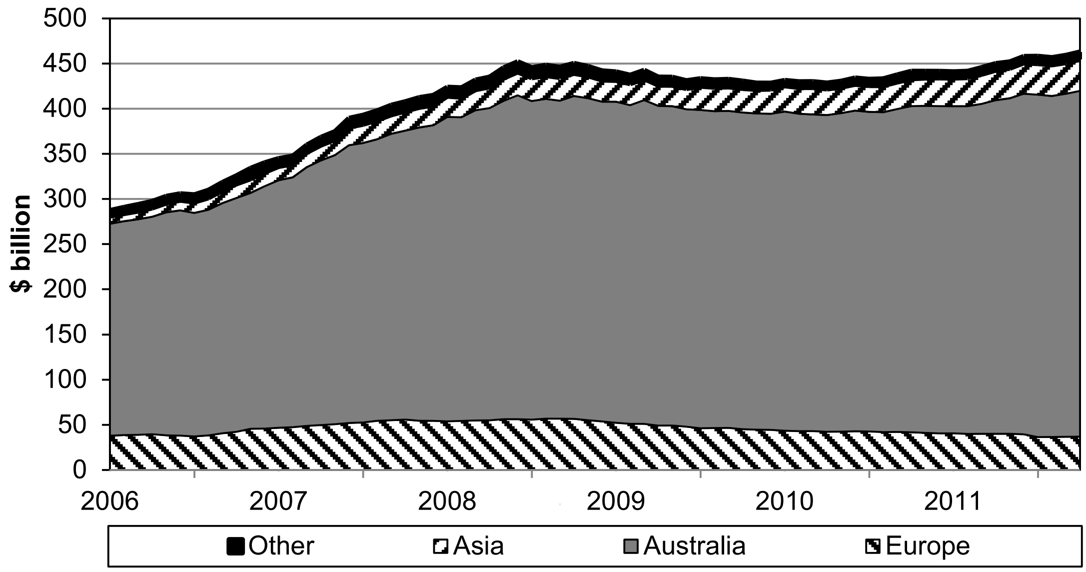
> In this market environment, EFIC and offshore export credit agencies play an important role in providing funding (whether directly or through provision of guarantees) particularly during a period when access to financing has been difficult and a number of market participants have been withdrawing. (sub. DR64, p. 2)

An imbalance between demand for, and supply of, capital is not a market failure — this happens in all markets. Balance is typically restored over time through changes in the market price (chapter 5). The Commission has found no convincing evidence to indicate there are regulatory or other barriers that impede access to debt or equity finance for large firms, or resource and infrastructure projects located in Australia, that would justify EFIC's involvement. The Commission has found:

- Following a dip during the GFC, lending by banks to non-financial corporations has returned to pre-GFC levels. While the amount of lending by European domiciled banks in Australia has declined by nearly 30 per cent since early 2009, this has been more than offset by increased lending by Australian and Asian domiciled banks (figure 7.1). In addition, Australian firms continue to access debt and equity in domestic and offshore markets, although finance may be more expensive than was the case prior to the GFC.
- Private sector investment in infrastructure over the past 10 years has nearly doubled (ABS 2011a). Investment in the mining sector, although declining slightly in 2009-10 following the GFC, has recovered to be about 20 per cent higher than its 2008-09 value (ABS 2011b).
- In recent years, many of EFIC's large clients have successfully raised finance in debt and equity markets. Some of the private debt issued by those firms was for tenor of 10 years or longer (chapter 3).

- Shortages of finance that limits future investment in infrastructure is generally not raised as an issue in the annual reports of EFIC's large corporate clients. Several of those clients have reported strong financial positions and were optimistic about their ability to finance future investments (box 7.4).

Figure 7.1 **Loans and advances to non-financial corporations, 2006–12[a]**



[a] Data relate to transactions conducted with residents (individuals, businesses, or other organisations domiciled in Australia), recorded on the domestic books of licensed banks. Data excludes transactions of overseas-based offshore banking units.

Source: APRA (2012).

Box 7.4 **Some of EFIC's large corporate clients report strong financial positions**

Leighton Holdings:

The Group has total available guarantee facilities of $3.5 billion of which only $2.9 billion has been utilised. The $650 million of undrawn guarantee facilities provides capacity for the continued growth in our business disciplines requiring these undertakings. (Leighton Holdings 2010, p. 3)

Santos:

Through proactive management of our balance sheet, we have built a solid capital position and are well placed to fund planned projects ... At the end of 2010, Santos has $7.8 billion of funding capacity, including cash and undrawn committed corporate and project debt facilities. (Santos 2011a, pp. 6–9)

McConnell Dowell:

Our balance sheet remains strong with $326 million cash in hand. We continue to invest in capital expenditure reflecting our increased work in hand. (McConnell Dowell 2011, p. 1)

EFIC has commented:

> Business credit growth remains lacklustre … This could be more a demand than supply side phenomenon. Companies (particularly mining companies) are funding themselves through retained earnings. The RBA estimates that internal funding currently accounts for 70 per cent of business funding, compared with 35 per cent in the mid 2000s. (EFIC 2012c, p. 5)

Furthermore, the head of institutional loan markets at the Commonwealth Bank of Australia (Salerno) stated:

> Deals of around A$500 million ($516.28 million) would continue to be aggressively bid by banks ... (Thomson Reuters 2012)

Salerno also added that although it may be difficult for borrowers to raise more than A$2 billion in the loan market due to difficulties with lending appetite, this 'will come down to pricing and structure'. Hence, in addition to volume, other features of transactions in the lending market are important determinants of participation by private providers.

Temporal dimension — is there value in EFIC bringing projects forward?

EFIC argued that its involvement helped bring projects forward that would have been unnecessarily postponed if left to private sector providers:

> … EFIC's retreat from onshore financing would imply slower resource investment and slower subsequent export growth. Contrary to the Commission's view, such deferred investment and exporting would not be a case of the market denying resources to uncommercial projects in the interests of efficient resource allocation. It would rather represent a sacrifice of real economic opportunity in the real term. (sub. DR90, p. 68)

The fact that some projects may be postponed because they are unable to secure financing arrangements is not necessarily indicative of a market failure. Inability to secure finance may indicate that the market requires more information about a project before it is willing to participate in it. There are many other potential reasons for the postponement of projects that could be accounted for entirely by commercial factors. In these instances there is no 'sacrifice' of economic opportunity — capital is not infinite and it may be the case that there are economic opportunities in other parts of the economy that generate greater commercial returns. It may be more efficient for resources to remain in the ground for future development.

Further, the suggestion that real economic opportunity might be sacrificed unless government financing is supplied appears to imply that labour and capital are sitting idle. Were this the case, consideration of whether EFIC had the ability, and the most appropriate means by which to address such a problem, would arise. If resources were not idle, bringing some projects forward would come at the expense of others and displace other forms of economic activity.

Availability of capital for large firms and resource-related projects — implications for suppliers

The Commission's conclusions on the availability of capital for resource-related projects in Australia (and large companies that export) has implications for suppliers of goods and services to those projects. A commercially viable resource-related project that has secured private sector support provides a clear domestic source of demand for the output of the supplier that is backed by the financial resources, credit history and commercial track record of the main contractor. The Commission considers there is no convincing evidence of failures in financial markets that are impeding the provision of financial services to suppliers to resource-related projects by private sector providers. The decision by a private sector provider to supply financial services to suppliers will be based on a commercial judgement that considers, among other things, the firm's capacity to deliver on the supply contract. An inability by a supplier to secure finance from a private sector provider may indicate that other firms are better placed to fulfil the contract or are more efficient suppliers.

FINDING 7.2

There is no convincing evidence that there are problems relating to the provision of capital to large Australian resource-related projects, or the suppliers to these projects, which require intervention by the Australian Government through EFIC.

7.2 EFIC's role in the allocation of resources in the economy

EFIC disagreed with the Commission's draft finding that there is no convincing evidence of market failures that affect access to capital for large firms, and for resource-related projects located in Australia. EFIC also considers that it *improves* efficiency in the economy by altering the allocation of resources. EFIC stated in its response to the Commission's draft report:

> … if market failure is present and an ECA such as EFIC is a fitting response to those failures, EFIC does not crowd out other more valuable projects, or private financiers. To the contrary, EFIC serves to crowd *in* finance and insurance to worthwhile projects that otherwise wouldn't gain support, and is thereby improving the efficiency of resource allocation in the economy. (sub. DR90, p. 24)

As discussed above, the Commission does not consider that the market gap concept is sufficient to ensure that EFIC's activities are restricted to addressing inefficiencies in financial markets caused by market failure. Participants to this inquiry have presented evidence to the Commission of EFIC assisting firms in circumstances that the Commission does not consider to constitute a market failure. In some instances, calls for EFIC's assistance are based on private decisions about preferred business models and firms' risk preferences rather than failures in financial markets.

Further, chapter 6 highlighted the importance of EFIC pricing its products and services efficiently, the difficulty of achieving this outcome under the current arrangements including the exemption from competitive neutrality policy. It also included the finding that some of the facilities supported by EFIC are subsidised. Inefficient pricing, in combination with targeting situations that do not constitute market failures will generate distortions in the economy.

In the absence of a market failure, EFIC's support for a project (or transaction) on the basis it is 'worthwhile' but not supported by the private sector results in a misallocation of resources. There are two possible outcomes from EFIC's involvement where no market failure is present, both of which reduce the efficiency of resource allocation:

- EFIC's support results in projects that would not have proceeded otherwise. This would occur if EFIC subsidised the facility that enabled the project to proceed
- EFIC supports projects that would have proceeded without EFIC's involvement.

These outcomes are discussed below, followed by a discussion of the potential for EFIC to crowd out other providers of finance and insurance, other sources of finance, other projects, and domestic competitors to EFIC's clients.

EFIC as the catalyst for projects that cannot attract private sector support — distortions caused by the absence of market failure

Private sector providers of export finance and insurance make decisions about the allocation of scarce resources between alternative projects. Where financial markets function well, the resulting allocation represents the highest valued use of the capital and would be efficient from the perspective of the Australian community. The market clearing price would reflect the economic cost and value of the resources to the community at the margin.

As discussed in chapter 6, a private sector provider will not support a project if the cost of allocating capital is such that it cannot earn a commercial return on the project. That is, the market clearing price is insufficient to attract private sector support for the project. Where there is no market failure EFIC must offer its financial services at a price lower than the market clearing price for the project to proceed[1]. EFIC could do this:

- by offering its financial services at a price that does not reflect the expected full cost of provision, including the opportunity cost of capital. That is, if EFIC subsidised that transaction
- on the basis it is a more efficient provider of financial services than the private sector.

The Commission found in chapter 6 that some facilities provided by EFIC are subsidised and noted that benefits derived from its exemption from competitive neutrality arrangements mean EFIC does not face the same incentives as private sector providers to improve its operational efficiency (discussed further in chapter 8).

If EFIC is the catalyst for otherwise uncommercial projects (see box 7.5 for evidence presented to this inquiry), this would have the dual effect of encouraging a greater level of investment than is efficient in areas that receive EFIC's support and the drawing of resources away from more productive uses, including parts of the economy that are export-oriented.

The resulting misallocation of resources imposes a cost on the Australian community by shifting resources from areas where consumers and firms would direct them, as determined by commercial returns, and instead directing those resources to the production of goods and services that would not be produced without assistance provided by EFIC.

1 For simplicity, this considers the case where EFIC's offer is identical to the private sector offer in all regards other than price. The same analysis would apply if EFIC's offer in total was generally more attractive even if the price was slightly higher.

Box 7.5 **EFIC's activity presented as a catalyst for export transactions and projects**

Submissions to this inquiry by clients of EFIC have stated that transactions they have undertaken would not have proceeded without EFIC's involvement.

Emtivac Engineering submitted:

> We have recently obtained a major contract … in Saudi Arabia. It was only possible for us to accept this order with the assistance of EFIC. (sub. DR77, p. 1)

Gasco stated:

> Without the support of EFIC, Gasco could not have financed and secured two major export projects in the Oil and Gas industry. (sub. DR82, p. 1)

Similarly, Joan B Peters suggested:

> As the executive producer on the $11.2 million feature film 'Drift', I can say that this film, starring Hollywood's number one action star, Sam Worthington, would not have been financed without EFIC's assistance. (sub. DR44, p. 1)

WorleyParsons submitted to this inquiry:

> The EFIC support received by WorleyParsons has complemented the facilities provided by the private sector and as a direct result of this support, WorleyParsons has secured overseas projects that it would not otherwise have secured. (sub. DR39, p. 1)

EFIC's relatively small size limits the economy-wide consequences of such distortions. However, some of EFIC's facilities are of sufficient magnitude to pose non-trivial financial risks to the Commonwealth. These risks would be increased significantly if the Australian Government were to accept the proposition advocated by Citibank and the ANZ to increase EFIC's maximum exposure limit per transaction. Citibank, for example, noted that other ECAs can have financial exposure to a single transaction of greater than $500 million (sub. DR108).

EFIC's support for projects that would have proceeded

Some of the transactions entered into by EFIC may have proceeded without EFIC's involvement — this would occur if EFIC was involved in a project or transaction that was regarded as commercially viable by the private sector. Accordingly, the Government would be needlessly involved in financing transactions that private sector providers would finance of their own accord (in the absence of market failure) without EFIC's participation.

As noted above the Commission found no convincing evidence of problems relating to the availability of capital for large resource-related projects located in Australia, including three supported by EFIC — the Brookfield rail upgrade, the Wiggins Island coal export terminal and the Santos LNG project at Gladstone. As the availability of capital for these projects was not impeded by failures in capital markets, EFIC's involvement is unnecessary because they would have proceeded anyway albeit maybe with different counterparties and less advantageous terms and conditions to EFIC's client (or should not have proceeded if they were not commercially attractive to the private sector). In either case, the cost of EFIC's involvement in these transactions is not insignificant. The capital employed has an opportunity cost and EFIC's support has unnecessarily imposed costs and transferred risk on to taxpayers.

Is EFIC crowding out?

Submissions have noted it is important that EFIC did not crowd out private sources of finance and insurance:

> EFIC needs to be careful not to crowd out potential commercial providers, nor to compete directly with products offered by commercial providers. (ACCI, sub. 5, p. 2)

> It is vital that the Export Finance and Insurance Corporation (EFIC) operates only in those parts of the market, where private sector business and industry associations do not provide services, either because the level of demand is not high enough or the operating costs are too high. (Business SA, sub. 6, p. 1)

Several private sector providers submitted that EFIC was not crowding out their services with some stakeholders noting that EFIC works in different markets to them. For example the Insurance Council of Australia noted:

> … that EFIC focuses on riskier, longer term export credit businesses and does not compete with the activities of Australian private sector insurers. (sub. 3, p. 1)

Westpac submitted:

> In no case have we seen evidence that EFIC is providing such support inappropriately, or in a way that 'crowds out' commercial institutions. Quite to the contrary, in our observation a number of transactions have proceeded *only* because of EFIC or other ECA support, due to commercial constraints in areas including total funding availability or lack of sufficient credit appetite. (sub. DR97, p. 1)

Nevertheless, in the Commission's assessment some of EFIC's activities are creating a crowding out effect. This conclusion has been reached because, as noted previously, the market gap mandate is not sufficient to ensure that EFIC will only undertake welfare-enhancing projects or transactions that are impeded by failures in financial markets.

Where crowding out occurs, this will lead to the situation where EFIC may crowd out:

- other providers of export finance and insurance
- other sources of capital available to EFIC's client
- alternative projects that may have been undertaken by clients
- domestic firms competing with the firm EFIC is assisting.

EFIC's participation in financial markets where market failure is not present will also entrench the status quo of EFIC's support and prevent the development of private sector capacity to provide export finance and insurance.

Crowding out other providers of export finance and insurance

Where EFIC provides export finance or insurance to a project or transaction that would have proceeded without its support — EFIC will crowd out the private sector provider. In the absence of market failure, the marginal provider of finance or insurance required to make the project or transaction proceed will be displaced by EFIC. This will impose a cost on that firm as well as taxpayers.

Crowding out other sources of capital or other projects

As discussed in chapter 3 there are a number of alternative means by which a firm can raise funds to finance export transactions and projects. The fact that private sector providers may not be willing to extend some financial services to firms for certain projects does not necessarily preclude them from accessing finance altogether, particularly in the case of large or publicly owned firms. Large firms typically have equity to absorb losses, assets to provide security and collateral that can be used to secure finance. If EFIC is supporting firms that could secure finance from elsewhere, including shareholders and other investors, then public funds are crowding out private funds in the financing of a project and risk is unnecessarily transferred to taxpayers. Boxes 7.6 and 7.7 provide examples of large publicly listed firms that have received EFIC's support.

Alternatively, lack of access to other sources of finance may reflect the underlying business case of the project or transaction or that it is beyond the financial capacity of the firm to undertake that transaction. In this case, in the absence of support from EFIC, the firm may have elected to undertake an alternative project that would generate the highest expected returns to that firm.

Crowding out domestic firms that are competing with the firm EFIC is assisting

Where there is no market failure, EFIC's support will disadvantage domestic firms that are competing with the assisted firm. This is illustrated by EFIC's support for Greyhound Australia (box 7.2) that was not based on a market failure. EFIC stated it stepped in to *ensure* Greyhound Australia was able to win the contract to supply transport services for mining staff when the firm's banks were unwilling to provide a performance bond on terms acceptable to Greyhound Australia. It is possible a more efficient firm would have provided those services if EFIC had not intervened.

This situation will arise even where EFIC's support is provided directly to the buyer of an Australian export. Consider the example where EFIC provides buyer finance to purchase a ship from an Australian boat builder — had that buyer finance not been available from EFIC it may have been the case that another Australian boat builder would have made the export sale.

Box 7.6 **EFIC facilities provided to large companies**

EFIC typically extends a number of facilities to large companies involved in big projects each year. Table 7.1 provides examples of large companies assisted by EFIC in 2010-11.

Austal Limited, a ship builder, has benefitted from facilities provided by EFIC a number of times in the past several years. For example, in 2008-09 Austal received support from EFIC in the form of an export finance guarantee of $61 million (EFIC 2009a). Austal also received $58 million of export finance guarantees from EFIC in 2007-08 (EFIC 2008a). For the year ended 30 June 2011, Austal Ships earned just over $500 million in revenue and made a profit after tax of almost $22 million. At 30 June 2011, the company held assets worth almost $675 million and had a total equity of $274 million (Austal Limited 2011).

WorleyParsons has also benefitted from EFIC's assistance. In the 2009-10 financial year, EFIC signed a $100 million bonding line facility with the company (EFIC 2010a). At 30 June 2010, WorleyParsons had total assets of about $3.6 billion and total equity of more than $1.8 billion. For the 2009-10 financial year, the company received total revenues of almost $5 billion and earned a net profit after tax of $290 million (WorleyParsons 2010).

Box 7.7 **Announcement by Santos of export credit agency support for the Gladstone LNG project**

In partnership with three other companies, Santos is constructing a LNG facility at Gladstone in Queensland (the GLNG project), for the processing of coal seam gas to be sold for export. On 23 December 2011 Santos announced that it has secured US$1.2 billion in export credit agency supported corporate debt facilities, including $248 million from EFIC (EFIC 2012f; Santos 2011c). The balance of Santos' contribution is to be sourced from the proceeds of capital market issuance and a sell-down of Santos' interest in the project to 30 per cent (EFIC pers. comm., 9 December 2011).

A media release issued by Santos stated:

> Santos Chief Financial Officer Andrew Seaton said the ECA facilities were part of Santos' funding strategy announced in late-2010 and demonstrates the company's ability to source capital from a diverse range of sources on attractive terms. (Santos 2011c, p. 1)

The media release also quoted the Santos Chief Financial Officer:

> We continue to maintain a strong balance sheet. With these new debt facilities, Santos will have more than $7 billion of available funding capacity, including cash and committed corporate and project debt facilities. (Santos 2011c, p. 1)

In its submission to the draft report, Santos commented:

> The scale of the Gladstone LNG project and the requirement that all participants share the risk also dictates that funding must be raised from multiple sources. In this market environment, EFIC and offshore export credit agencies play an important role in providing funding … particularly during a period when access to financing has been difficult and a number of market participants have been withdrawing. (sub. DR64, p. 2)

The export credit agency facilities are summarised in the table below (Santos 2011c).

Facility	*SACE facility*	*EFIC facility*	*Uncovered facility*
Facility limit	US$280 million	$248 million	US$670 million
ECA	SACE, Italy	EFIC, Australia	EDC, Canada
Maturity	Amortises over 8.5 years following GLNG project completion	Amortises over 8.5 years following GLNG project completion	2019
Joint coordinating arranger and mandated lead arranger	ANZ HSBC	ANZ HSBC	ANZ EDC
Mandated lead arranger	Citi	Citi	-
Lending parties	ANZ HSBC Citi	ANZ HSBC Citi	EDC ANZ BTMU CBA NAB

Entrenching the status quo

The preceding discussion on crowding out considers the situation where there are competitors in the economy — either other providers of export finance and insurance or other producers of goods and services that may be exported — that are being displaced by EFIC's activities in financial markets.

However, crowding out is not limited to these circumstances. For example, EFIC's activities may be preventing private sector providers from developing the requisite capacity to support export transactions. This would occur if EFIC obtained and utilised first-mover advantages over the private sector in assisting a particular exporter or industry, or in providing financial services in a particular country. EFIC has claimed to have first mover advantages in some areas of its operation, considering this as one of the unique features of an ECA. EFIC stated in its submission to the Commission's Issues Paper:

> … if a government owned ECA has been in business for a long time, and has built up a large portfolio of assets, it will enjoy economies of scale that give it a first-mover advantage over private sector entrants to the market. (sub. 18, appendix A, p. 13)

The Commission has also found that some of EFIC's clients receive support on a recurrent basis (chapter 2, box 7.8).

Importantly, crowding out will occur even if EFIC provides some of its facilities at the market price. The costs of switching to an alternative provider may prevent its clients from moving even if EFIC's price for those facilities is the same or slightly higher than in the private sector. The Commission considers that the outcome where EFIC becomes entrenched as a source of finance or insurance for some firms is inefficient in the long run. This is also inconsistent with the Minister's Statement of Expectations (SOE) and the EFIC Act. EFIC is to encourage other providers to finance or assist in financing exports, rather than provide a long-term solution to an exporter's finance and insurance needs.

The multiplier effect — is it simply multiplying the distortions?

Participants in this inquiry argued that EFIC generated benefits to the economy based on multiplier methodology. EFIC, for example, noted that there would be multiplier effects arising from ECA intervention to cushion the impacts of financial crises on the provision of trade finance (sub. DR90). The basic theory underlying multiplier effects has been outlined in chapter 5.

Inquiry participant Austal Limited stated:

> Over the course of the last decade, EFIC's involvement has meant Austal's export sales have been nearly 60 per cent higher than they would otherwise have been.
>
> The benefits of those EFIC-supported projects include:
>
> - Nearly $800 million in export revenue for Australia
> - Approximately 3400 person-years of direct full time employment at Austal — that is 340 jobs for 10 years …
> - At least $1.1 billion additional value to the local economy as a result of the multiplier effect
> - Additional employment and other multiplier effects into the local economy … (sub. DR110, p. 9)

The use of multipliers to quantify the impact of an activity or government policy on the economy will likely overestimate its benefits for a number of reasons. First, the counterfactual outcome in EFIC's absence is unknown. For example, it is possible that the buyers of Austal Limited vessels may have found alternative sources of finance or that Austal Limited may have found other buyers for its vessels where ECA intervention was not provided. Indeed, Austal Limited may have even entered into other export contracts where ECA support was not a factor.

Second, leaving aside the empirics of estimation, domestic multiplier effects will tend to be muted where there are 'leakages' in expenditure and production to offshore sources. If it is the case that the 3400 person-years of direct employment at Austal Limited referred to in the submission are not located in Australia, the claimed multiplier effects may be overestimated. Austal Limited confirmed during the hearings that the majority of its workforce is based offshore. In addition to its operations in Western Australia, Austal Limited recently established a commercial ship-building operation in the Philippines and also has operations in the United States dedicated to manufacturing ships for the United States Navy. Roughly 2700 people are employed in Austal Limited's US operations in contrast to 400–500 in Western Australia (trans., pp. 27–8).

Although Austal Limited is majority Australian-owned and most of its profits are repatriated to Australia (trans., p. 28), the domestic multiplier effects of its production activities would be limited to the degree that any assistance provided generated activity in its overseas production facilities as opposed to its Australian production centre. This makes arguments for particular policy arrangements based on domestic multiplier effects even less relevant.

Further, as discussed in chapter 5, the Commission disagrees with the premise of targeting government intervention on the basis of generating multiplier effects because interventions of this sort ignore the opportunity cost of the resources involved and their associated multiplier effects. In addition, where the intervention does not address a market failure, any distortions in the allocation of resources would also be multiplied. Viewed in this context, the greater the claimed multiplier effect of an inappropriately targeted intervention, the greater the resulting distortion within the economy and the larger the net cost imposed on the broader community.

FINDING 7.3

Where EFIC's activities are not addressing a market failure, EFIC will be distorting the allocation of resources within the economy. These distortions include potential crowding out of other sources of finance, other projects, or competitors of EFIC's clients.

At present, EFIC's relatively small size limits the economy-wide consequences of this. However, some facilities are of sufficient magnitude to pose non-trivial financial risks to the Commonwealth.

Equity effects and resource allocation

EFIC's activities in financial markets also have implications for the manner in which resources are distributed between exporting firms (and, more recently, suppliers to exporting firms) within the Australian economy. This, in turn, brings up considerations of the equity of these distributional effects.

When EFIC intervenes and enables a project or transaction to proceed that would not have otherwise done so, the exporting company, its workers, and associated industries will benefit by being able to produce and sell more output for export. Where private sector providers of finance and insurance are involved in the transaction, they also share in the benefits of EFIC's participation.

The beneficiaries of EFIC's assistance are relatively few — it services only a small number of Australia's 45 000 exporting firms. Some of those firms are large, well-established and able to access other (albeit possibly more costly) sources of export finance and insurance. However, because EFIC is distorting the allocation of resources in the economy, the costs are widespread and include those borne by domestic competitors of EFIC's clients and, more broadly, the taxpayer.

7.3 EFIC and the incentives of others

The Commission has received many submissions from EFIC's clients and financial sector partners indicating their support for EFIC's services. It is not unusual that supported firms put forward arguments for continued government intervention that improves their returns or reduces their risks. Similar arguments were used against the dismantling of import tariffs.

This section reviews the impacts of EFIC's presence on the various parties involved in the transactions in which it participates.

EFIC and private sector providers

EFIC often conducts business with an exporter in conjunction with financial institutions (usually the exporter's or buyer's bank). EFIC notes:

> One of EFIC's functions is to encourage banks, other financiers and insurers to support exports and overseas investments. Our participation in larger transactions can often encourage private financiers to share the risks involved. (EFIC 2011a, p. 39)

In other words, EFIC — with the aim of supporting exports — undertakes transactions where it accepts some or all of the private provider's risk in individual transactions. For example, after announcing its support for a water supply project in Sri Lanka, EFIC commented:

> This project is a good example of how EFIC can work with a commercial bank to support the financing of Australian exports on terms which may exceed the bank's risk appetite. (EFIC 2010b)

To this end, EFIC has products and arrangements in place that reduce risk for private sector providers. Some examples include:

- *documentary credit guarantees* transfer the risk of default by a buyer's bank on payments due under a documentary credit (also known as a documentary letter of credit), that the exporter's bank has confirmed, from the exporter's bank to EFIC
- *export working capital guarantees* encourage banks to extend working capital to exporters by transferring the risk of default on the loan from the exporter's bank to EFIC
- *risk sharing agreements* have been established with some Australian banks in which EFIC shares a proportion of the risk of non-payment by an overseas buyer with the exporter's bank.

After signing its Master Working Capital Agreement with EFIC, the Commonwealth Bank of Australia commented:

> The benefit of this arrangement between Commonwealth Bank and EFIC is that exporters can access working capital finance, without having to provide as much security for the loan as we would require without EFIC's guarantee. (CBA 2011)

The law firm Latham and Watkins submitted:

> … some commercial lenders are willing to participate in certain high-risk projects only to the extent that they benefit from ECA cover. (sub. DR51, p. 3)

Similarly, the Australian Institute of Export stated:

> … vanilla term trade deals into offshore markets is not where our banks wish to lend. Unless of course the international risk aspects have been wrapped up by an EFIC facility. (sub. DR107, p. 3)

Thus, private sector providers can be significant beneficiaries of arrangements with ECAs. For example, a loan guarantee provided by EFIC transfers the risk of non-payment of the loan from the private sector provider to EFIC, and ultimately to taxpayers not involved in the export activity. While the guarantee is outstanding, taxpayers in effect are holding a contingent liability (and an opportunity cost is incurred as a result of this financial exposure). The price of the guarantee needs to reflect this opportunity cost and the risk of the transaction. If the price is not sufficiently high to do so, then uncompensated risk is transferred to the taxpayer to the benefit of the private sector provider — it is a subsidy.

In the event that the borrower fails to repay their loan and the guarantee is called, the private sector provider will still receive repayment of the loan it extended, in full, or in part, but this payment will come from EFIC. As EFIC is wholly owned by the Australian Government, payment made from EFIC's reserves is effectively the same as if it was made by the Australian Government itself.

In some instances, the provision of support by EFIC induces private sector providers to carry out transactions that they otherwise would not have because EFIC's involvement makes those transactions more commercially attractive.

This is not to imply that such relationships are improper, as was EFIC's interpretation of the Commission's draft finding (sub. DR90, p. 29), just that this is a consequence of EFIC's partnership arrangements where it assumes its partners' transaction risks.

In some cases, the relationship between banks and EFIC is built into a bank's business model and appears to be almost symbiotic in its characteristics. The ANZ, for example, lists structured export finance in partnership with ECAs as part of its products package and this partnership gives their clients 'access to an additional source of competitively priced, long-term debt for major capital and infrastructure projects' (ANZ 2011, pp. 23–4). The ANZ also noted in its submission:

> EFIC support can therefore be fundamental to ANZ's preparedness to offer extended tenors for certain obligors that would not otherwise be available without EFIC support, or with support from private sector insurers. (sub. 20, p. 4)

This indicates that there is an incentive for financial institutions to develop their business models based on the presence of ECA support, rather than developing their business models to *replace* ECA (or in this case EFIC) support.

The Commission's proposed model for EFIC's future role would utilise its relationships with private sector providers in relation to newly exporting SMEs. EFIC has proven its capacity to work closely with private sector providers but its reformed role will be to demonstrate that providing financial services to newly exporting SMEs can be commercially viable.

ECAs and syndicated lending

Private sector providers are also likely to benefit from EFIC's involvement in project finance or other forms of participatory loans as ECAs may also act as a source of gap financing or insurance to ensure projects go ahead. Several participants (for example, sub. DR42; sub. DR108; sub. DR51) suggested this was the case.

The benefits of this arrangement for EFIC's partners in a syndicate is illustrated stylistically in figure 7.2 building on the example used in chapter 6. In a syndicated loan transaction banks and institutional investors will place bids for debt in a transaction. The borrower or finance arranger will offer an interest rate they believe will attract the required finance or raise the interest rate offered until the required amount of funding is achieved. However, the borrower cannot pay more than their expected return on the project. For syndicated loans it is typical for all lenders to receive the same price for the funds they contribute (given the type of finance contributed, for example, subordinated debt), with the price set by the interest rate bid by the marginal lender. In panel A, lenders A, B and C are willing to provide funds below the maximum price the borrower can pay. But other lenders such as lender D require an interest rate above the maximum price and so the market price for funds exceeds the project return and the project does not go ahead.

In these situations, the borrower may invite EFIC to participate in the financing of the project. In panel B, EFIC takes the place of lender D. In accordance with the SoE, EFIC is not to undercut the pricing of the private sector, but may match the pricing of the co-financiers (in this case lender C). In this example, the offer price is still below what would have been offered by the marginal lender (D) in the absence of EFIC. In this case, the project achieves the required financing, as the price is set to generate a positive project return. If there had not been ECA involvement the project would not have gone ahead.

For the other lenders EFIC's involvement permits the project to go ahead and they are able to recoup super-normal profits (rent) (indicated by the shaded areas) from the transaction. In addition, the finance arranger will earn fees on the successful transaction and if it underwrote the debt, ECA involvement reduces its risk in addition to other potential ECA risk mitigation effects present for all lenders.

It may also be the case that the involvement of ECAs creates an incentive for borrowers to understate their project return or willingness to pay a higher rate in the knowledge that an ECA may fill their financing gap without the need to raise the price they offer. In some cases, this ECA may step in for reasons other than commercial returns such as improving resource or energy security. Underpricing may not be transparent to lenders whose required interest rate was above the price offered by the borrower but below that which would have been offered had an ECA (or EFIC) not filled the supposed gap (for example, if the project return in figure 7.2 was actually above the marginal price of lender D). As such, a lender may not be aware if an ECA has undercut its pricing, and if it were aware, ECA involvement in other transactions may reduce the lender's incentives to report the underpricing.

FINDING 7.4

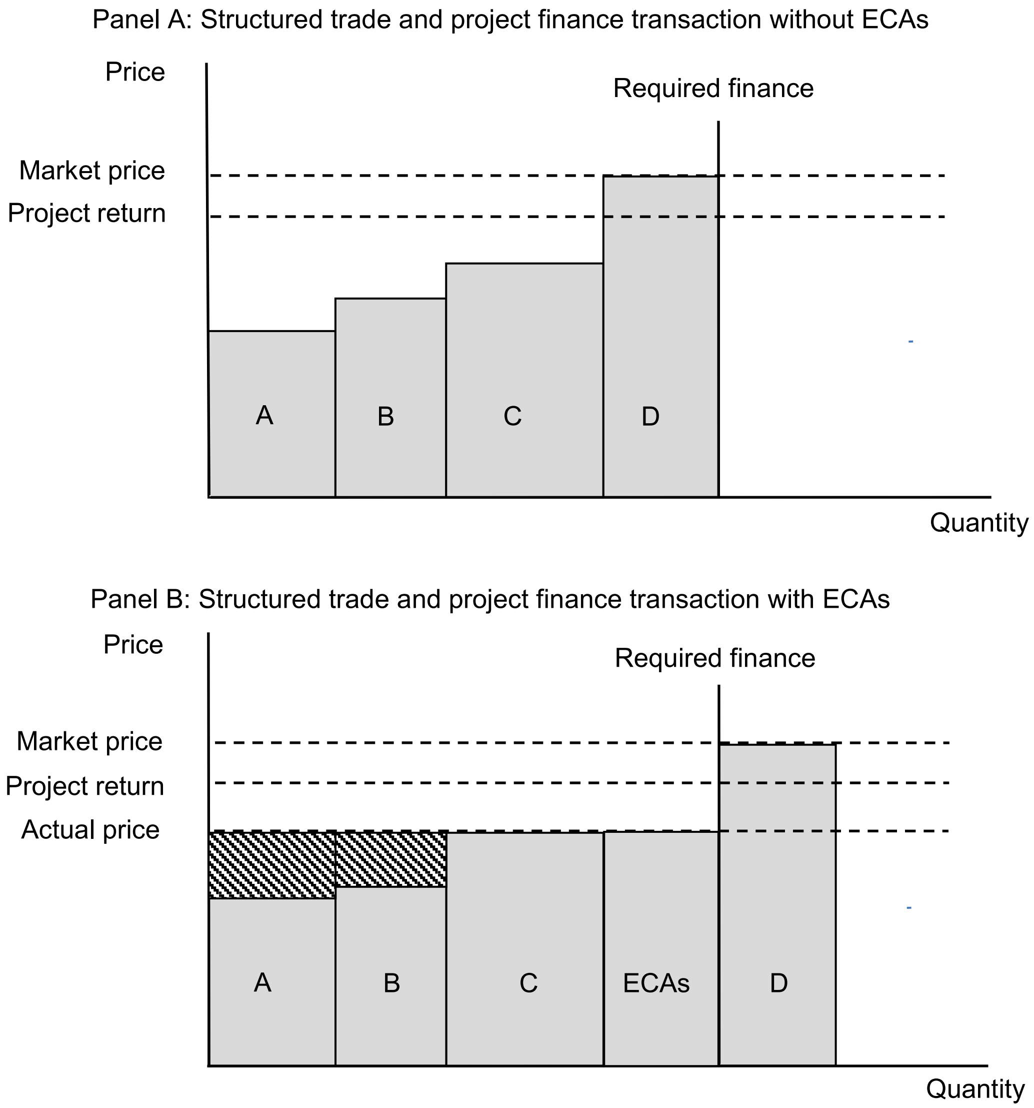
Some financial market participants have a partnership relationship with EFIC, being able to benefit directly from EFIC's involvement in facilities, through both risk transfer and higher returns.

EFIC and exporters

The vast majority of exporting Australian firms neither need nor receive EFIC's assistance. When EFIC provides a loan, guarantee, insurance or other product to an exporter, it confers an advantage on that exporter that is not shared by other firms servicing the same market — potentially more efficient firms. As Podbury et al. (2001) observed of agricultural export credit programs:

> … just like an explicit export subsidy, such programs could be expected to penalise efficient agricultural producers who do not have access to concessional credits … (pp. 92–3)

Figure 7.2 **The role of ECAs in structured trade and project finance**



In the absence of market failure, the most profitable export projects would be expected to receive finance and insurance and the private sector would be willing to undertake these transactions. It may be the case that firms seeking support from EFIC are more risky propositions (or less attractive commercially) than other firms in the industry. It is also possible that firms might adjust their behaviour if EFIC offers more favourable terms and conditions on products than those that could be obtained from private providers alone. On the latter point, the Chief Financial Officer of Whitehaven Coal listed a number of potential benefits of export credit financing facilities generally:

- the potential for a longer tenor as compared with other bank debt
- the flexibility to provide for full amortisation reduces refinance risk

- the reallocation of a lender's exposure to the export credit agency frees future capacity of the lender to assist a borrower with more traditional financing needs, and
- significantly lower overall cost on a like-for-like basis against a corporate bank debt equivalent (quoted in Freehills 2011).

There may also be risks of suboptimal decision making leading to a less efficient allocation of financial and other resources. For instance, firms may enter into transactions that would not be profitable without EFIC support or firms may increase their exposure to politically unstable countries if they consider it likely a transaction will be supported by EFIC.

Austal Limited remarked:

> Certainly EFIC has played a key role in facilitating the sale of many Austal vessels … EFIC's participation has firstly helped the client to secure their total financing requirement … and typically has also helped to reduce the cost of the overall finance package. (sub. DR110, p. 8)

This demonstrates how EFIC support may become an entrenched part of an exporter's business strategy. For example, the provision of more than 20 documentary credit guarantees to Shark Bay Salt since 2009-10 suggests there may be little incentive for some exporters (or the private sector) to change their business models (box 7.8).

In reference to export credit facilities in general, a partner at the law firm Freehills stated:

> Export credit financing facilities are a viable and effective option for many Australian companies, particularly mining industry participants, and should be considered as part of a company's broader financing strategy. (Freehills 2011)

If the provision of export finance can be undertaken on a commercial basis and there are no market failures present, then the private sector should be willing to take on those transactions. If they are not provided by EFIC on a commercial basis, then the firms receiving EFIC's support are being subsidised and the incentive to improve firm level efficiency is dulled. It also means that private providers cannot compete on the same terms.

Box 7.8 **One salt producer's multiple credit guarantees**

EFIC has provided a salt producer, Shark Bay Salt, with more than 20 documentary credit guarantees for salt exports to Indonesia since 2009-10 (EFIC 2011a, 2012f).

In its submission to the draft report, EFIC stated it provided the support because Shark Bay Salt's Australian bank could not confirm letters of credit due to its internal counterparty and country limits on Indonesia. Moreover, it stated that the cost to Shark Bay Salt of moving to another bank was prohibitive.

EFIC has not provided any support to Shark Bay Salt's Australian competitors, yet the majority of salt production is exported in bulk from northern Western Australia — a large share of this salt is exported to South East Asia, including Indonesia.

Three points arise from this example:

- There is no inherent need for EFIC to assist Shark Bay Salt, demonstrated by other salt producers being able to export without this assistance.
- EFIC's support allows Shark Bay Salt to avoid the business costs of switching banks — giving it an advantage against competing salt producers.
- EFIC's support lowers the cost to the bank of meeting its internal prudential policies.

7.4 In sum

In chapter 5, the Commission has considered the range of rationales that could justify government intervention to provide export finance and insurance services. It has found no grounds for the government provision of export finance and insurance services through EFIC — with the exception of the provision of limited assistance to newly exporting SMEs to overcome information-related failures in financial markets including, in some circumstances, to newly exporting SMEs for a limited time when financial markets are temporarily disrupted. Proposed reforms to reorient EFIC toward intervention to address these potential inefficiencies are presented in chapter 10.

In chapter 6, the Commission outlined the importance of EFIC pricing its financial services to cover the expected full cost of provision and analysed how EFIC sets the prices for its facilities. It found that the techniques adopted by EFIC did not ensure economically efficient pricing. It was found that some of EFIC's facilities are subsidised.

In this chapter, the Commission has analysed the economic impacts of current arrangements, and in particular, the combined effect of EFIC acting outside of the scope of market failure and of not recovering the expected full cost of providing its financial services. In particular, the Commission has found:

- the concept of the market gap is not equivalent to market failure and EFIC has, at times, taken part in projects and transactions where no market failure was present
- EFIC's (relatively small) contribution to resource-related projects in Australia is likely to have crowded out another provider of finance or source of equity or alternatively, for those projects that would not have proceeded without EFIC's assistance, it has diverted resources from other parts of the economy
- EFIC's involvement generates a benefit for a small number of clients and parties to the transaction. However, the costs are borne by others in the economy, including the direct competitors of the assisted firms and the taxpayer.

8 Financial management and performance

Key points

- A large proportion of EFIC's income is earned through its treasury. EFIC's origination business, responsible for supporting exports through loans, guarantees and insurance products, has generated less than half of EFIC's income in each of the past five years.
- Although EFIC has recorded modest accounting profits in 19 of the past 20 years, it is unlikely that it has covered the full economic cost of providing its financial services.
- In the recent past, EFIC has had high exposures to certain industries, notably ship-related industries, indicating that some aspects of its credit risk management have not always been sufficiently robust.
- EFIC maintains capital well above prudential minimums and EFIC's internal limits. The capital held by EFIC has an opportunity cost that is borne by the taxpayer.
- Over the past ten years, EFIC's activities on the commercial account have earned a low rate of return on equity. This may reflect a number of factors, including that its transactions are sometimes not priced to reflect the expected full economic costs (given the risk incurred), a high level of retained capital, and possibly high operating expenses.
- EFIC's operating expenses have increased significantly over the past five years, particularly its staff costs. Although increased costs have been accompanied by an increase in some of EFIC's reported output measures, there has not been a commensurate increase in its profitability.
- Rigorous assessment of EFIC's operational efficiency will not be possible until it is subject to competitive neutrality arrangements and operates on an equal footing with private sector providers.

The Export Finance and Insurance Corporation (EFIC) earns income from two sources: its origination business, which derives fees and interest from loan, guarantee and insurance products, and a separate treasury which invests capital and surplus borrowing proceeds. The origination business is further separated into a structured trade and project finance (STPF) division, which supports large transactions often involving large Australian and foreign companies, and a small and medium-sized enterprises (SME) and mid-market division. This chapter examines the financial performance of EFIC as a corporation, the way in which it manages its credit and funding risks, its capital adequacy, and treasury functions.

8.1 Risk management

According to its policy documents, EFIC is required to manage the credit risks in its portfolio, that is, the risk of impairment for each facility, and risk concentrations across its portfolio. EFIC's policies also require ongoing monitoring of facilities and portfolio exposures and for EFIC to set aside funds in case of losses. This is done through general provisions for expected losses, specific provisions for known losses and capital for unexpected losses. EFIC's policies also state that it should set aside capital for operational risk and market risk, and additional capital, known as concentration capital, to manage concentration risk in its portfolio (EFIC 2008b).

EFIC's credit risk and portfolio concentration management policies

EFIC's risk management framework includes a credit manual (EFIC 2008b) and a risk appetite statement. According to EFIC policy, both of these documents must be approved by the Board and are subject to ongoing revision.

EFIC's credit manual sets out the policies and processes for credit risk assessment. Before providing a facility, EFIC is required to determine whether it meets the eligibility criteria specified in the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act) (chapter 2). If the transaction meets the eligibility criteria, EFIC assesses the risk of the proposed transaction using procedures specified in the credit manual. This process includes an assessment of the aggregate portfolio risks associated with the proposed transaction, with regard for other exposures in the portfolio, as well as the specific risks associated with the proposed facility (box 8.1).

Box 8.1 **Risk profile of EFIC's portfolio**

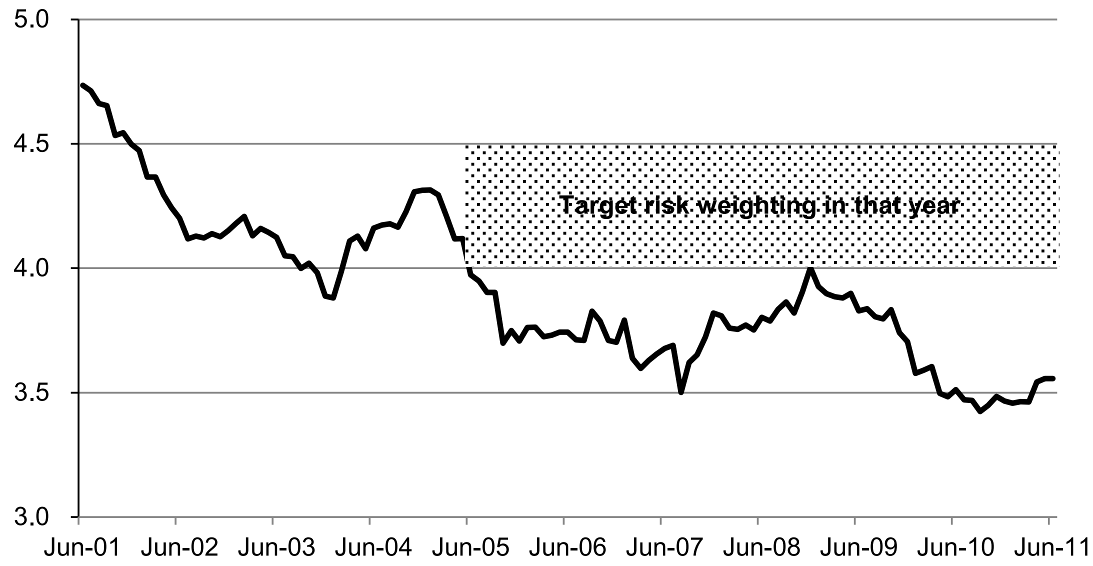
EFIC's website notes:

> EFIC's lending business is essentially similar to a wholesale corporate banking business, although the risk profile is different from that of a typical bank. We have a more concentrated portfolio of generally longer-dated and higher-risk exposures, consistent with our role of working beyond the limits of the commercial market. (EFIC ndk)

Average risk across EFIC's portfolio can be examined by looking at average risk scores and impairment:

- At 30 June 2011, the weighted average risk grade of EFIC's commercial account (CA) exposures, including political risk insurance policies and reinsurers, was an EFIC risk score of 3.6. This is equivalent to Standard & Poor's BBB or investment grade rating (box 6.4).
- EFIC's weighted average risk grade for 2010-11 was between 3.7 and 3.9 across the CA and the national interest account, again equivalent to investment grade. EFIC's weighted average risk grade has been falling in recent years.
- The overall level of impairment on EFIC's portfolio is low compared to that of other Australian banks (majors and regionals) (EFIC, sub. 18). Generally, the higher the level of risk undertaken, the higher the level of impairment.
- In 2010, Standard & Poor's estimated that EFIC's CA exposures would be consistent with a counterparty credit risk of about BBB (for example, Bank of Queensland has a long-term BBB credit rating). This assessment factors in Standard & Poor's observation of EFIC's portfolio being concentrated in the shipping, mining and construction sectors.

EFIC weighted average risk rating, commercial account



Sources: EFIC (2011a); S&P (2010).

EFIC's policies require assessment of a proposed transaction in light of the aggregate risks that EFIC is exposed to across the commercial account (CA). EFIC aggregates portfolio exposures according to the following categories:

- risk party — the entity on which EFIC assumes credit risk
- controlled risk party — any exposure EFIC may have to entities controlled by the risk party, such as subsidiaries or affiliates
- segment of risk — includes sovereign risk assumed by governments, bank risk assumed on the financial institution accepting short-term deposits and commercial risk, or risks not covered by either sovereign or bank risk
- country of risk
- industry of risk (EFIC 2008b).

Although EFIC is not subject to Australian Prudential Regulation Authority (APRA) oversight, EFIC states that its exposure management policies are modelled on APRA's guidelines for the maximum level of exposure to a single counterparty or to groups of related counterparties, known as the large exposure policy guidelines (box 8.2). EFIC sets maximum limits on counterparty exposures (to risk party or controlled risk parties) and countries. It has target limits expressed as a percentage of capital (including callable capital) to particular countries, industries and risk parties that depend on risk grade. Exposures above these limits are considered to be high and require approval by the Board (EFIC 2008b; 2011a).

Provided that aggregate risk levels are acceptable, EFIC will then assess the specific risks associated with the proposed facility. In order to manage its risk profile, EFIC sometimes shares risk through reinsurance and risk participation agreements with private insurers, other export credit agencies (ECAs) and multilateral agencies. EFIC reinsured 11.6 per cent of its exposures by value in 2010-11 (EFIC 2011a).

EFIC's policy requires board approval of all transactions of more than $50 million. The Managing Director has responsibility for all other transactions, but has delegated some powers to the chief credit officer or the head of the STPF or SME and mid-market divisions, who can co-approve transactions of up to $15 million (EFIC 2008b).

EFIC's aggregate exposures

EFIC has procedures set out in its credit manual that suggest that EFIC's board should be aware of exposure concentrations:

> [Aggregate risk exposure] tolerances have been devised so that decisions to incur large concentrations of industry or country risk in the portfolio will be taken at the highest

level of Management. Board control of material changes in such risk concentrations is exercised through any large individual transactions being referred to the Board for approval if the amount exceeds the delegation granted to the Managing Director. In addition, the Board monitors the spread of portfolio risk via regular reports. (EFIC 2008b, p. 1-4)

Box 8.2 **APRA's large exposure guidelines**

Under the Australian Prudential Regulation Authority's (APRA) large exposures prudential standard (APS 221), an authorised deposit-taking institution's (ADI) large exposures policy must, at a minimum, cover the following:

1. exposure limits, commensurate with the ADI's capital base and balance sheet, for:
   (a) various types of counterparties (for example, governments, ADI's and foreign equivalents, corporate and individual borrowers)
   (b) a group of related counterparties
   (c) individual industry sectors (where applicable)
   (d) individual countries (where applicable)
   (e) various asset classes (for example, property holdings and other investments)
2. the circumstances in which the above exposure limits may be exceeded and the authority required for approving such excesses
3. the procedures for identifying, reviewing, controlling and reporting large exposures of the ADI.

APRA considers a large exposure to be an exposure to a counterparty or a group of related counterparties which is greater than or equal to 10 per cent of an ADI's capital base. The aggregate exposure of an ADI to a counterparty or group of related counterparties is subject to the following limits:

1. external parties unrelated to the ADI (other than governments, central banks and ADIs or equivalent overseas deposit-taking institutions) — 25 per cent of capital base
2. unrelated ADI (or equivalent overseas deposit-taking institution) and its subsidiaries — 50 per cent of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 per cent of capital base
3. foreign parents and their subsidiaries — 50 per cent of capital base, with aggregate exposure to non-deposit-taking subsidiaries capped at 25 per cent of capital base.

APRA guidelines are not prescriptive about limits for individual industry sectors, countries or asset classes.

Source: APRA (2008).

EFIC's policy allows for the Managing Director to set limits on maximum industry exposures. Industry exposures are to be reviewed quarterly. EFIC's credit manual states that 'for the purposes of managing industry exposure, exposures to industries in excess of 15 per cent of EFIC's capital are considered high' (EFIC 2008b, p. 4-7). However, EFIC has advised the Commission that:

> We [EFIC] do not currently have any specific industry limits in place given that industry risks are viewed as well contained. (EFIC, pers. comm., 18 November 2011)

In 2010, EFIC's internal auditors observed some large exposures on the CA. These related to particular countries such as Zambia and Sri Lanka, and ship-related industries. The internal auditors recommended EFIC consider enhanced 'stress testing' and scenario analysis tailored toward country and industry specific risks. (EFIC, pers. comm., 25 November 2011). On the basis of the material presented by EFIC, the Commission understands that this internal audit recommendation was not adopted.

Box 8.3 shows the extent of EFIC's exposures to ship-related industries over time. EFIC stated in its submission to the draft report that exposure to ship building and operation is reported at every board meeting. EFIC also noted in its submission to the draft report that the internal auditors concluded in 2010 that EFIC was fully compliant with prudential limits set out in APRA's large exposure guidelines (sub. DR90). However, as noted in box 8.2, APRA guidelines are not prescriptive about industry limits.

The high exposure to ship building and operation drew the attention of the Board and EFIC's internal auditors. This suggests that EFIC's credit risk arrangements have not always been sufficient to prevent concentrated aggregate exposures.

FINDING 8.1

EFIC's internal auditors observed that EFIC has had high exposure to certain industries, including ship building and operation, and to a few countries.

The Commission considers that some aspects of EFIC's credit risk management have not always been sufficiently robust.

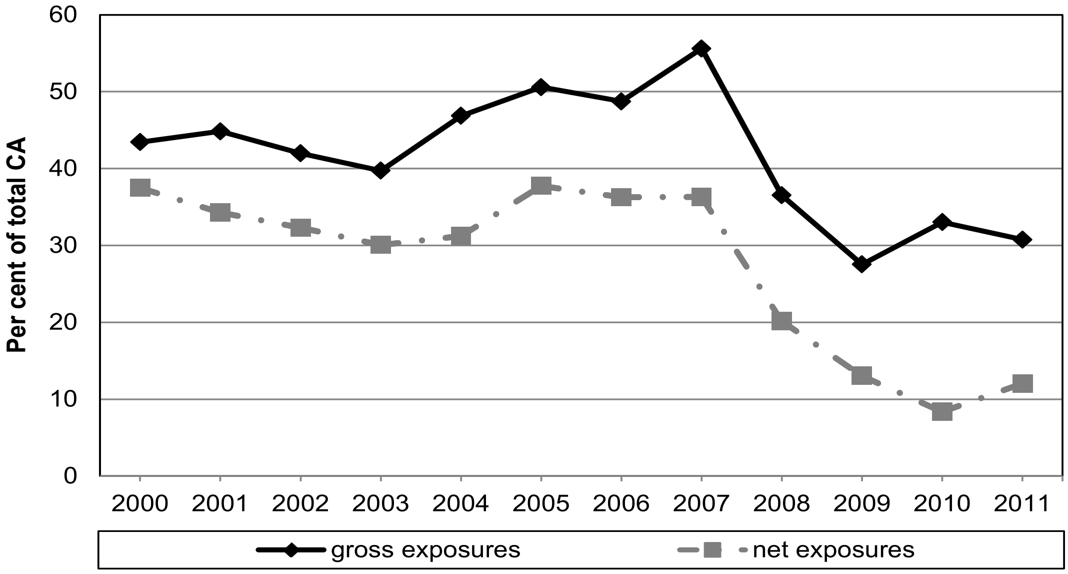
RECOMMENDATION 8.1

EFIC should revise its risk management policies to include a limit on exposures to particular industries.

Box 8.3 **EFIC's exposure to ship building and operation**

A large share of EFIC's commercial account (CA) credit exposure is (and has been) associated with ship builders and operators. In 2010-11, gross exposure on the CA was $294 million (31 per cent of total CA exposures, or 48 per cent of EFIC's capital, including callable capital). In 2006-07, EFIC's gross CA exposure to ship building was $365 million (56 per cent of total exposures, or 62 per cent of capital, including callable capital). Exposure excluding sovereign and semi-sovereign exposures and reinsurance was about 36 per cent of total exposures between 2005 and 2007. Such a high rate of exposure to one industry could expose EFIC to large losses if circumstances or events have an adverse impact on the facilities in the portfolio.

EFIC's exposure to ship building and operation[a]



[a] Exposure at 30 June. Net exposures excludes exposure to sovereign and semi-sovereign risk parties, and reinsurance.

The national interest account (NIA) also has some exposure to ships, accounting for 1.6 per cent of total NIA exposures in 2010-11, although this is fully reinsured. Across the CA and the NIA, EFIC's total gross exposure to ships was $305 million in 2010-11, or 19 per cent of total exposures.

Even with a reduction in the level of exposure in recent years, in 2010, EFIC's internal auditors observed 'concentrations in countries such as Zambia and Sri Lanka and industries such as shipping' (EFIC, pers. comm., 25 November 2011, p. 10) and called for enhanced stress testing and scenario analysis tailored towards country and industry-specific risks. On the basis of the material presented by EFIC, the Commission understands that this internal audit recommendation was not adopted.

Sources: EFIC (2011a; pers. comm., 25 November 2011; 1 December 2011).

Capital adequacy

When an insurance, guarantee or bond claim is made, EFIC may need to make a payment to counterparties, or in the case of a non-performing loan, will not receive repayments of interest and/or principal. Under the EFIC Act, the EFIC Board is required 'to ensure, according to sound commercial principles, that the capital and reserves of EFIC at any time are sufficient' (s. 56(1)). When making this assessment, the Board is required to include as capital the $200 million of callable capital that is available from the Australian Government. EFIC holds no capital against the national interest account (NIA) (EFIC, sub. 18), because the costs and risks are borne directly by the Commonwealth. Any losses or gains on NIA facilities impact the Commonwealth's obligations to potentially fund business conducted on the NIA. In some cases, the Commonwealth may be required to provide funding to EFIC (via the Department of Foreign Affairs and Trade) through an appropriation from the Consolidated Revenue Fund to achieve the Commonwealth's directives.

To assist in ensuring all its payment obligations are met, EFIC's policy requires funds to be set aside to cover impaired facilities on the CA. A general provision for expected losses and a specific provision for known losses, is made through EFIC's profit and loss statement. These costs are explicitly recognised in profit results contained in the financial statements.

Capital is set aside for unexpected losses (discussed in chapter 6), and is recognised in the financial statements as 'total capital required'. EFIC calculates total capital required (broadly) according to APRA and Basel II standards. Liquid assets are held against required capital and provisions, including cash and its equivalents, and financial securities of varying maturities which are 'available-for-sale'. EFIC also maintains credit lines to ensure that payment obligations can be met.

EFIC holds more capital than it estimates is required to cover unexpected losses. At 30 June 2011, EFIC's capital was $419 million ($619 million including callable capital). This exceeds EFIC's estimate of required capital of $286 million which includes concentration capital ($135 million) and estimated dividend payment ($15 million) (EFIC 2011a).

EFIC's capital adequacy ratio was 34.6 per cent, including callable capital (or 23.4 per cent without callable capital) (EFIC 2011a), well above both the 8 per cent minimum imposed by APRA on commercial banks and the minimum 16 per cent specified by the Board (EFIC, sub. 18) (box 8.4). By comparison, the weighted average capital adequacy ratio of Australian-incorporated banks in June 2010 was

11.7 per cent and the 90th percentile for capital adequacy ratios was 18.3 per cent (APRA 2011).

Box 8.4 **Capital adequacy**

EFIC bases its assessments of capital adequacy on the prudential standards and calculations used for regulating banks. The Board has endorsed a model that takes into account the Australian Prudential Regulation Authority (APRA) guidelines and the framework issued by the Basel Committee on Banking Supervision (known as Basel II). The model covers credit risk, operational risk, market risk, credit concentration risk and counterparty risk.

EFIC assigns probability of default statistics and loss given default ratios to each facility and calculates an amount of capital accordingly (discussed in chapter 6). Riskier, longer-dated facilities require more capital than the less risky, shorter-dated facilities. EFIC uses probability of default statistics published by the major ratings agencies and Berne Union statistics to assist in constructing the model.

In addition, EFIC sets aside additional capital to reflect what it considers is a concentration of large exposures. The amount of concentration capital is based on the highest of:

- 100 per cent of the largest individual maximum exposure
- 50 per cent of the largest maximum country exposure (excluding internal credit rating 1 and 2), or
- 50 per cent of the largest maximum industry exposure (except reinsurance and central or local government).

The sum of the required capital for all facilities, the capital against treasury exposures on EFIC's investments and derivative transactions, and operational capital are added to determine capital before concentration capital. Risk weighted assets (RWA) are calculated by dividing this amount by the minimum capital required by APRA (8 per cent).

The capital adequacy ratio is calculated by dividing capital by RWA. APRA requires banks to hold capital of no less than 8 per cent of RWA.

Source: EFIC (2011a).

As a wholly owned government entity, EFIC does not face the same incentive to productively manage capital as a private sector firm. In publicly-listed companies, holdings of liquid assets by a firm in excess of prudential requirements can be interpreted as a signal that the firm lacks profitable investment projects. Firms with large cash holdings will usually seek to improve profitability by using liquid assets to make profitable investments, pay down debt or return the excess funds to shareholders through dividend and other payments. With the exception of publicly-listed companies with partially paid shares and some insurance markets, there are few public or private organisations with capacity for management to call on owners to provide additional capital. EFIC's dividend payment policy is discussed below.

EFIC's corporate plan notes EFIC's intention to lower its capital adequacy ratio over the next three years by expanding its operations and increasing the level of its risk weighted assets (EFIC 2011c). The effect of EFIC's high level of retained capital on its operating performance is discussed in section 8.4.

FINDING 8.2

EFIC's capital adequacy ratio at 30 June 2011 was well above the minimum level specified by Australian Prudential Regulation Authority guidelines and EFIC's internal benchmarks. The extra capital held by EFIC has an opportunity cost that is borne by the taxpayer.

8.2 Dividends

Under the EFIC Act, EFIC is required to pay a dividend to the Australian Government. Although the Board recommends the dividend to the Minister, the Minister may direct payment of a different specified dividend (s. 55), provided it is not more than EFIC's profit for that year (s. 55(4)). The criteria for setting the specified dividend are not prescribed in the EFIC Act and the Minister is not required to provide an explanation for the specified level of dividend. In recent years, the dividend payment has been 50 per cent of profit on the CA, with EFIC retaining the remaining 50 per cent. The Minister directed EFIC to pay a dividend of 75 per cent for the 2009-10 financial year (EFIC 2011a).

EFIC has used the retained portion of profits it has made over the past 10 years to build its equity from $238 million in 2002 to $408 million at 30 June 2011:

> EFIC is a profitable agency making an average profit of A$33 million a year and returning A$106 million in dividends to Government since the last Review [of EFIC in 2006]. The balance of profits is retained to increase EFIC's capital base to support more exports. (EFIC, sub. 18, p. 3)

However, the Australian Government has indicated to Government Business Enterprises (GBEs) that it prefers dividends over capital gains and:

> The level of estimated dividends shall be driven by the desired capital structure, the profitability of the enterprise, and the level of agreed future capital expenditure. (Department of Finance and Deregulation 2011, p. 26).

More information on the dividend policies of other GBEs can be found in appendix D.

8.3 EFIC's treasury

EFIC states that the objective of its treasury is to minimise the cost of funding loan assets and maximise the return on its investments (EFIC 2011a). Treasury operations are carried out within a framework agreed by the Australian Government and are subject to internal and external audits (box 8.5).

EFIC's treasury operations are also constrained through legislation and by EFIC's Board. Under the *Commonwealth Authorities and Companies Act 1997* (Cwlth) (CAC Act), the Minister for Finance requires EFIC's treasury investments to be in entities (known as counterparties) rated AA- or better, or for authorised deposit-taking institutions (ADIs), a rating of BBB- or better. EFIC's Board has also imposed maximum levels of exposure to individual counterparties according to their risk rating.

EFIC's chief credit officer and chief financial officer may jointly approve treasury transactions, provided the size of the transaction is below the limit approved by the Board for the risk rating of the counterparty, and the transaction does not exceed any other country or counterparty limits. EFIC policy is that these limits should be reviewed on an ongoing basis (EFIC 2008b).

EFIC's treasury is relatively small in comparison to those of other government enterprises, but accounts for a large proportion of EFIC's income (EFIC, pers. comm., 18 November 2011). EFIC's origination business has accounted for less than half of EFIC's income in each of the past five years (figure 8.1). EFIC noted in its submission to the draft report that treasury income went directly to government until May 2007 (sub. DR90).

A large part of the income from EFIC's treasury comes from a large investment ($1.3 billion at 30 June 2011) in liquid assets (including cash and equivalents, and available-for-sale securities). Some of this investment is supported by EFIC's borrowings, which was $2.4 billion at 30 June 2011 (EFIC 2011a).

In its submission to the draft report, EFIC noted that it considers that income from its investment of capital and reserves would more accurately be included in its origination income (sub. DR90) on the basis that the earnings are EFIC's. The Commission considers that EFIC's capital and reserves are owned by the Australian Government on behalf of taxpayers and have been provided for the purposes of meeting the objectives of the EFIC Act, not for general investment of the Government's financial resources.

Box 8.5 **EFIC's treasury**

EFIC has stated that the core function of EFIC's treasury is to obtain competitive rates on its borrowings and to manage the reserves that represent EFIC's capital base (EFIC 2011a). The main functions of EFIC's treasury are to:

- borrow on international and domestic capital markets to fund its business activities
- manage the Australian Government's equity investment in EFIC
- structure Australian dollar and foreign currency cash flows arising from transactions
- enter into derivative contracts to manage currency and interest rate risk.

EFIC must have the approval of the Minister for Finance to borrow under s. 59 of the *Export Finance and Insurance Corporation Act 1991* (Cwlth). The Minister has approved three funding programs at 30 June 2011:

- US dollar medium term notes (MTN)
  - US$1.2 billion, limit of US$2 billion
- Australian dollar MTN
  - $1.2 billion, limit of $1.5 billion
- Euro-commercial paper (ECP) (short-term borrowings)
  - US$390 million (US$115 million funds export loans and US$275 million funds market recognition program), limit of US$1.5 billion.

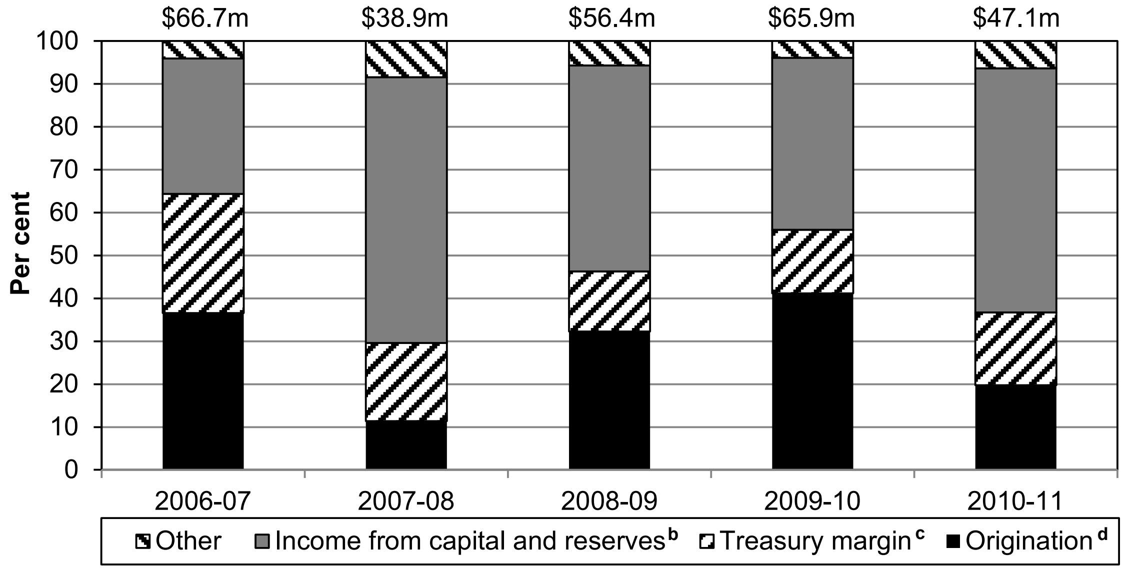
The EFIC Board also approved three investment programs in 2011:

- capital and reserve portfolios, where equity is invested
  - about $400 million
- surplus liquidity portfolio, where surplus cash is invested when the borrowing and lending profile do not exactly match
  - $837 million
- market recognition program that enables EFIC to maintain a presence in the ECP market for name recognition purposes to facilitate the maintenance of credit lines, and, therefore, MTN issuance. EFIC's relatively small size means that investors might not otherwise be familiar and comfortable with EFIC's debt
  - about $300 million.

The funds raised through these programs must be invested in accordance with the *Commonwealth Authorities and Companies Act 1997* (Cwlth), in particular, s. 45 of the Finance Minister's Orders, although the EFIC Board may determine additional criteria.

Source: EFIC (pers. comm., 21 October 2011).

Figure 8.1 **EFIC earns less than half of its income through origination[a]**



[a] Total income includes all revenue earned on the commercial account net of the allowance for credit risk, reinsurance and interest expenses. [b] Income from capital and reserves is net of the allowance for credit risk, but includes income from investments and foreign exchange. [c] Treasury margin income includes interest margins, liquidity margin, allowance for derivative risk and a fair value adjustment in 2006-07. [d] Income from the origination business may vary from year to year because of differences in the volume of business undertaken and accounting conventions for provision for expected losses. However, only actual losses affect EFIC's long term profitability.

Sources: EFIC (pers. comm., 24 November 2011; 5 December 2011).

FINDING 8.3

A large proportion of EFIC's income is earned through its treasury operations, with EFIC's origination business accounting for less than half of its income in each of the past five years.

The Commission considers that EFIC's treasury operations should be commensurate with the size of EFIC's origination business and the type of financial services offered. A reorientation of EFIC's operations in response to the Commission's recommendations would require treasury operations to be realigned accordingly or replaced with alternative arrangements.

Alternative arrangements for EFIC's four main treasury functions (box 8.5) could lead to lower overall costs than those of EFIC's current treasury arrangements. The extent of any savings from alternative arrangements can only be rigorously assessed once the scope of EFIC's future origination activities are determined by the Australian Government.

As discussed in chapter 6, application of competitive neutrality arrangements will provide EFIC's treasury with greater commercial discipline. Specifically, it will provide the incentive to hold capital having regard to its opportunity cost and ensure that EFIC takes into account all costs when pursuing its objective of minimising borrowing costs.

Alternatives for EFIC's four main treasury functions include:

- retaining the functions in EFIC
- placing some functions with another Australian Government agency
- outsourcing some functions to a private sector provider under a competitive tender arrangement.

These alternatives will involve costs, including for the agency and for EFIC to establish arrangements to manage the outsourcing contract, which should be compared to the costs of retaining the function within EFIC (table 8.1). The management of currency and interest rate risk (through derivative transactions), investment management and cash flow structuring could be retained by EFIC, undertaken by another Australian Government agency (on a competitively neutral basis) or outsourced to a private provider. The Australian Office of Financial Management (AOFM) is prohibited under its enabling legislation from raising funds in foreign currencies.

EFIC's borrowing activities could be undertaken by the AOFM. The main advantage of borrowing from the Commonwealth through the AOFM is that the cost of funds may be reduced. Notwithstanding EFIC being able to use the Australian Government's AAA credit rating, it pays a premium on its borrowings because it is not as well recognised as the Australian Government in domestic and international financial markets and its debt is considered to be less liquid.

If EFIC borrowed from the Commonwealth through the AOFM, it could be treated in the same manner as other Australian Government agencies that borrow from the Commonwealth. For example, the AOFM provides funds to Defence Housing Australia (DHA) at a rate that includes a margin based on the credit rating of DHA and on the market rates applying to entities with similar credit ratings. This is reflected as a 'debt neutrality charge' in DHA's loan agreement with the Commonwealth (Department of Finance and Deregulation, pers. comm., 27 April 2012; 10 May 2012).

Table 8.1 **Options for management of EFIC's treasury functions**

<table>
<tr><th></th><th>EFIC</th><th>AOFM</th><th>Other Government agency</th><th>Private sector</th></tr>
<tr><td>Borrow</td><td rowspan="4">Employs 5.4 full-time equivalent staff to undertake all treasury functions. Incurs compliance costs such as meeting reporting and audit requirements</td><td rowspan="2">No additional staff required at the AOFM, although there would be additional compliance costs, such as meeting reporting and audit requirements. These may be lower for the AOFM than for EFIC due to economies of scale</td><td>Borrow directly from the Australian Government's Consolidated Revenue Fund through an appropriation</td><td>x</td></tr>
<tr><td>Invest</td><td rowspan="3">Cost determined by competitive tender on a competitively neutral basis</td><td rowspan="3">Cost determined by competitive tender</td></tr>
<tr><td>Structure cash flows, including foreign exchange</td><td>x</td></tr>
<tr><td>Manage currency and interest rate risk</td><td>x</td></tr>
</table>

x Option is unlikely to be least cost.

Sources: AOFM (pers. comm., 10 May 2012); EFIC (pers. comm., 24 November 2011; 16 January 2012).

Under the Commission's proposed new arrangements for EFIC, it is likely that borrowing would only be required for the NIA, although the other options for borrowing would be suitable if there were reasons that EFIC needed to borrow to support facilities on the CA, for example, if EFIC retained capacity to provide direct loans or funded guarantees (table 3.2).

RECOMMENDATION 8.2

The Treasury and the Department of Finance and Deregulation should regularly review the need for, and the scope of, EFIC's treasury function to ensure that the size of treasury operations is commensurate with the size and product offering of the origination business it supports.

The first review of this type should include an assessment of EFIC's capital requirements and dividend policy, and be completed by June 2013.

8.4 EFIC's financial performance

Under the Statement of Expectations (SoE), the Minister states that 'EFIC's Commercial Account operations are to be conducted on a commercial basis, obtaining a return reflecting risks, and national interest account operations should normally be conducted on this basis' (Emerson 2011, p. 2).

Consistent with its SoE, the Commission considers that it is appropriate that EFIC:

- recovers the expected full costs of its facilities (including opportunity costs) (chapter 6)
- operates efficiently.

If EFIC is achieving these objectives, it will be operating on a commercial basis, generating economic profits (discussed in chapter 6) and should earn an appropriately benchmarked return on equity (box 8.6). Where EFIC provides a facility that is not priced to earn an appropriately benchmarked rate of return on equity, and recover the expected full costs of provision, or is not operating efficiently, the taxpayer is not fully compensated for the risk EFIC incurs on the taxpayer's behalf.

In the course of this inquiry, EFIC has asserted that it has performed well financially. It has identified three reasons for this assessment:

- It has regularly earned accounting profits.
- Its return on equity has been above the return on Australian Government bonds.
- The Minister and Australian Government central agencies have not expressed dissatisfaction with its returns.

Accounting profit

A key aspect of EFIC's response to the draft report is that it has recorded accounting profits in 19 of the past 20 years:

> The quality of EFIC's internal governance framework, systems and procedures is reflected in: … Almost 20 years of unbroken profits — since November 1991, through a series of global and regional economic shocks, EFIC has been profitable in 19 of the past 20 years … (sub. DR90, p. 53)

EFIC has made modest accounting profits, has retained these profits or returned them to the Government in the form of a dividend in most of the past 20 years, and has not required direct support from the Government for operating expenses (apart from the initial equity investment).

Box 8.6 Return on equity

Return on equity (RoE) is a commonly used measure to assess the financial performance of a firm. It measures how well management has performed in generating wealth for the shareholder, in EFIC's case, the Australian Government on behalf of taxpayers. Return on equity is equal to the operating profit after all expenses, as a percentage of the equity invested in the business (such as contributed equity and retained earnings).

The market's expected RoE will not be the same for every asset or business, and will usually take into account risk, which will also affect the volatility of RoE over time. Investors will typically demand a higher RoE for higher risk businesses and assets, and expect more volatility in the RoE. An average RoE over longer periods may provide a more relevant measure in markets or periods with high volatility.

Rates of RoE are only informative as comparisons to relevant benchmarks. Benchmarks can include assets that are risk free (to ensure RoE includes a premium for risk), assets with the same level of risk and assets in similar industries. It is also important to compare RoE with benchmarks based on the same definition of profit, including whether profit is before or after tax.

RoE is not the only relevant benchmark for assessing financial performance. A rigorous framework for assessing performance would also include other measures such as return on assets, asset quality and leverage ratios. However, RoE provides a useful headline measure which is commonly used and easily understood, calculated and compared.

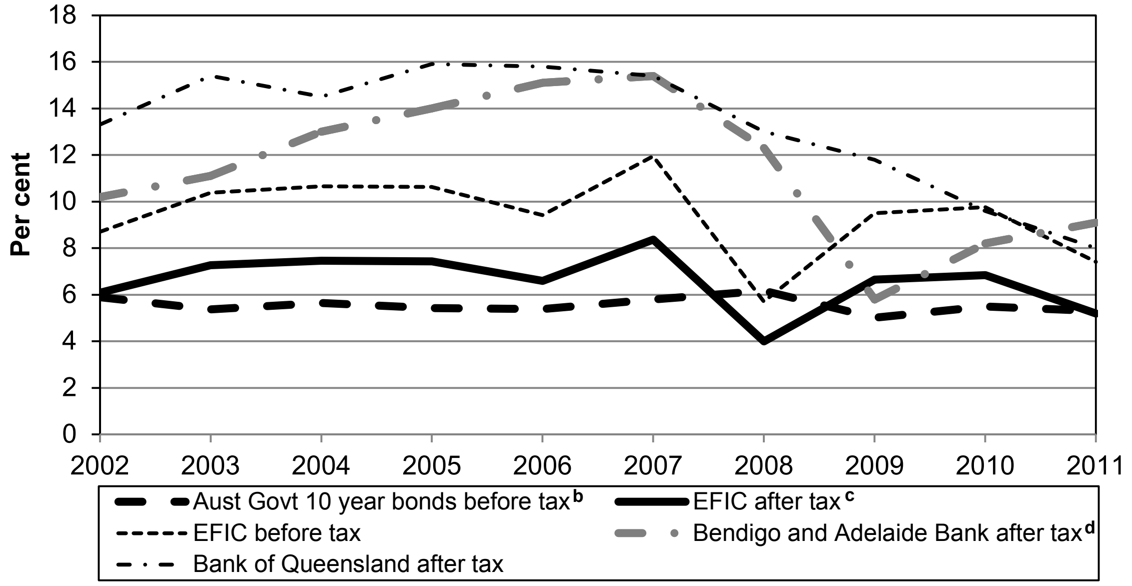
However, EFIC's exemption from competitive neutrality arrangements means that its accounting profits do not take into account the expected full cost of providing its financial services, including income tax expense, the opportunity cost of capital and lower borrowing costs arising from the Australian Government's guarantee. As such, EFIC's accounting profits do not provide an accurate reflection of EFIC's economic profitability. Indeed, because EFIC's treasury borrows in financial markets at a low rate, and lends surplus funds, and capital and reserves to financial markets at market rates, earning accounting profits is not a high hurdle to jump.

Importantly, a modest accounting profit (especially one driven by its treasury operations and the return on the investment of the Australian Government's equity) does not prove that EFIC's finance and insurance activities are generating a net benefit to the Australian economy.

Return on equity

Commission estimates of EFIC's after-tax return on equity suggest it ranged between 4.0 and 8.4 per cent, and averaged 6.6 per cent, over the past 10 years (figure 8.2). On average, this is below that of the Bank of Queensland (13.3 per cent) and Bendigo and Adelaide Bank (11.4 per cent), both of which are of comparable size to EFIC (EFIC, sub. 18), and have a similar credit rating to EFIC's CA (BBB) (S&P 2012a; 2012b).

Figure 8.2 **EFIC's financial performance — low returns to government equity[a]**



[a] For financial institutions, the benchmark is the after-tax return on equity as reported by each financial institution in its annual report for the year ending 30 June (Bendigo and Adelaide Bank, EFIC) or 31 August (Bank of Queensland). [b] The average of daily quoted capital market yields for Australian Government 10 year bonds for the financial year ending 30 June. [c] Commission estimates of EFIC's after-tax return on equity are based on a tax rate of 30 per cent. [d] For the Bendigo and Adelaide Bank, the quoted return on equity before 2007-08 is for the Bendigo Bank.

Sources: Bank of Queensland (2002–2011); Bendigo and Adelaide Bank (2008–2011); Bendigo Bank (2002–2007); EFIC (sub. 18); RBA (2012b).

In its submission to the issues paper, EFIC highlighted as evidence of its financial performance that its:

> … average annual return on equity over the period [since 2006] was approximately 8.9 per cent compared to the ten-year government bond rate over the same period of 5.7 per cent. (sub. 18, p. 3).

However, the return on Australian Government bonds (considered low risk given the Australian Government's AAA credit rating) alone does not represent an adequate benchmark for EFIC's financial performance, given the risk EFIC incurs on the CA.

At public hearings, EFIC explained why it considers that its returns have been adequate:

> Our argument about return has been very simply that we price individual transactions to market, so we believe that we are delivering what the market would expect as a rate of return. (trans., p. 291)

Pricing its financial services to match the prices of other providers in the market is not sufficient to ensure that EFIC is operating efficiently. For instance, it does not ensure that EFIC is delivering its products at an efficient price, including operational costs and the opportunity costs of its capital (discussed in chapter 6).

EFIC's low rate of return on equity indicates the Australian Government has not received an adequate return for the risk it has incurred from EFIC's operations.

External scrutiny of performance

EFIC has also noted as evidence of its sound financial performance that the Minister and Australian Government central agencies have not raised issues with the forecast rate of return provided in its corporate plan or annual financial presentations (EFIC, trans., p. 154; pers. comm., 14 Oct 2011).

The lack of clarity in the information provided by EFIC is likely to have reduced the ability of other government agencies to judge its economic performance (chapter 9). At present, EFIC's performance management framework is not adequate to assess EFIC's performance and ensure that EFIC is operating efficiently and generating a return for the Australian Government and taxpayers that is commensurate with the risk it incurs.

Benchmarking

The rate of return a firm or government agency earns is a useful indicator of financial performance when compared against relevant benchmarks (box 8.6).

EFIC has argued against comparing its operations to other financial institutions:

> In general it is not appropriate to compare EFIC with other financial institutions in the private sector due to its mandate to operate in the market gap. For example, private sector institutions seek to increase returns for shareholders by maximizing profits. While EFIC is expected to be profitable, its main objective (and statutory mandate) is to facilitate and encourage Australian export trade where the private market is unwilling or unable to provide support. As a result of its mandate, EFIC does not have a well-diversified portfolio of risk either by borrower type or by product offering. It does not have, for example residential mortgage or credit card businesses, which form a

> significant part of regional and major bank portfolios and are major drivers of their profitability. (sub. 18, appendix A, p. 2)

And:

> The premise we've disagreed with is that our returns would be comparable to the Australian banking system. (trans., p. 286)

The Commission considers that although EFIC's business is different from that of many of Australia's banks, the relevant consideration is the return it earns relative to the risk it incurs. As such, comparison of the return on equity of banks and other financial institutions relative to the risk of their business (and consequent volatility of their profits) provides a benchmark to assess EFIC's financial performance. Using financial indicators from major or regional banks as a benchmark does not mean the Commission is recommending that EFIC operate in the same way as those businesses.

In practice, benchmarking the financial performance of government businesses is difficult. The Australian Government Competitive Neutrality Complaints Office noted:

> Benchmarking is seldom easy. For instance, it can be difficult to isolate specific factors affecting an individual firm's return from underlying market performance. In addition, it is sometimes difficult to find comparable firms or industry averages for some government activities … While benchmarking may lack the appearance of precision, it nevertheless incorporates the activity's level of market risk into the target setting process and provides a useful basis for setting or comparing returns. At the very least, the performance of other firms in an industry cannot be ignored when judging the performance of a government business. (CCNCO 1998, pp. 5-6)

The Commission considers that appropriate benchmarking of EFIC's financial performance could involve comparison of EFIC's returns against a benchmark that is commensurate with the risk incurred and informed by a range of financial indicators, such as the yield on financial securities and return on equity of other financial institutions with similar levels of risk (and consequent volatility of their profits). The Minister should set an appropriately benchmarked rate of return on equity, in consultation with the Treasurer and the Minister for Finance, which should be reflected in the Minister's SoE (chapter 6).

Appropriate benchmarking of EFIC's financial performance will improve the transparency of EFIC's performance to Government. It will also provide a more credible demonstration to the private sector of the commercial viability of serving the market.

Explaining EFIC's financial performance

If EFIC's return on equity is consistently below that of appropriate benchmarks, it suggests that:

- not all of EFIC's facilities are priced to reflect the expected full costs of provision, including the opportunity cost of capital (chapter 6), or
- EFIC is not as operationally efficient at providing financial services as private sector providers because it has:
  - a conservative business model, retaining a large amount of capital to protect against insolvency or against calling on the Australian Government guarantee
  - high operating expenses relative to income.

Retained capital

As noted earlier in this chapter, EFIC retains capital well above regulatory minimums and EFIC's internal limits. In its submission to the draft report, EFIC stated that its return on equity reflects that it 'holds more capital to reflect its concentration risks, a function of the niche in which it is required to operate' (sub. DR90, p. 48), and that this lowers its return on equity. However, the Commission does not consider a market failure (or even a market gap) mandate requires EFIC to deliver low returns to the Government's equity investment.

EFIC has identified its high capital holdings as the main reason for its low reported return on equity, and outlined its rationale for maintaining a relatively large amount of capital:

> If our return on equity is at odds with your expectations, it does not reflect our pricing, it does not reflect our costs, it certainly doesn't reflect our losses. It may reflect, I think in fact we argue it does reflect, our capital base.
>
> There are two elements to that. Firstly, we are asked to do a great deal with our capital base, that is, we need to provide significant limits against our capital base and [second] we have to have a significant cushion. (trans., p. 291)

The first element EFIC has identified is a need to maintain a large amount of capital in order to be able to provide large facilities while maintaining large exposure limits consistent with APRA guidelines, which are based on a percentage of capital (including callable capital).

The second element identified by EFIC is that its high level of capital provides a 'cushion', or buffer, against insolvency risk arising from unexpected events. In relation to its high capital holdings, EFIC stated that this:

> … gives a high degree of assurance to Government and the taxpayer that EFIC will be financially self-sustaining and will not call on the Government guarantee. (sub. DR90, p. 48)

The Commission notes that retaining capital in order to minimise the risk of calling the guarantee is not a relevant indicator of financial performance, as the capital held by EFIC, as well as callable capital, are both owned by the Australian Government on behalf of the taxpayer.

In its submission to the draft report, EFIC stated 'Capital in excess of 16 per cent is necessary to support concentration risks arising from large export contracts and exposures' (sub. DR90, p. 45). The Commission noted earlier in this chapter that EFIC holds capital in excess of its requirements, even after taking into account its requirement to cover concentration risk.

The Commission considers that if EFIC's facilities require a large amount of capital to satisfy concentration capital requirements, then the cost of holding this additional capital should be recovered from these facilities. Where providing large facilities reduces EFIC's return on equity, it suggests that the Australian Government is undercompensated for the concentration risk borne on these facilities.

It may also be the case that the cost of EFIC providing large facilities may be higher than that of private sector providers due to its relatively small balance sheet. The application of competitive neutrality arrangements to EFIC's activities would ensure that it faces the full cost of providing the additional capital against large exposures and improve the incentive for EFIC to use its capital efficiently.

Capital requirements are imposed by regulators on financial institutions principally to protect depositors. They also benefit shareholders. However, for shareholders, there is a tradeoff between the benefits of maintaining high levels of retained capital and the cost of doing so. Although it is necessary that EFIC maintains capital to meet appropriate prudential standards, retaining capital to the extent that it is inefficiently used and generates a low rate of return compromises EFIC's claim that it is a successful commercial enterprise.

In the 2012-13 Budget, the Australian Government made an allowance for a special dividend of $200 million to be paid from EFIC's capital and reserves (Australian Government 2012).

RECOMMENDATION 8.3

The Export Finance and Insurance Corporation Act 1991 should be amended to allow the Minister to direct the Board of EFIC to return capital to the Australian Government when the Minister determines that EFIC has surplus capital, after seeking the views of the Treasurer and the Minister for Finance.

Operating expenses

A potential contributing factor to EFIC's relatively low rate of return on equity may be high operating expenses, and low operational efficiency, compared to that of private sector providers.

A common measure of cost performance in the banking industry is the cost-to-income ratio — the standard definition of which is non-interest costs (excluding bad and doubtful debts) divided by the total of net interest income and non-interest income. The focus on non-interest costs reduces the volatility caused by changes in interest rates (Tripe 1998).

In its submission to this inquiry, EFIC stated that its cost-to-income ratio, which ranged between 36.6 and 48.8 per cent over the past four years, is consistently below that of Australian regional banks, and was below that of the major banks in 2008-09 and 2009-10 (sub. 18, appendix A). However, as noted by EFIC (sub. 18), the cost-to-income ratio can vary significantly based on accounting policy. Of particular importance is how accounting policy makes allowance for credit risk.

The use of the cost-to-income ratio to compare financial institutions with different business models has flaws, as it can be affected by non-performance characteristics. For example, as identified by Tripe (1998), a financial institution that reduces its branch network could use the savings to increase its interest rates in order to attract funds from other sources such as institutional lenders, improving its cost-to-income ratio without affecting the institutions' profitability. Likewise, EFIC's reported low cost-to-income ratio may reflect that its business model is to source funds from domestic and international capital markets (which it is able to do at a relatively low cost because of the government guarantee). In contrast, banks operate branch networks with high non-interest costs to obtain funds from depositors.

Also, as noted by EFIC, banks generally do not separately report on their cost performance for their institutional or corporate banking arms:

> In the banking sector that is probably most relevant to EFIC from the perspective of corporate or institutional … the banks don't actually report on a segment basis on that. (trans., p. 298)

Although using financial ratios to benchmark EFIC's operational efficiency against that of other financial institutions has limitations, examination of EFIC's operating expenses can provide some indication of how well it is performing in constraining its cost growth over time. EFIC's nominal CA operating expenses have increased by 58 per cent in the past five years, from $15.5 million in 2006-07 to $24.5 million in 2010-11. Staff costs (wages, provision for employee entitlements and superannuation) are EFIC's largest expenditure item representing about 50 to 60 per cent of its total operating expenses. Staff costs increased by 53 per cent from 2006-07 to 2010-11 (EFIC 2007–2011).

Over the same period, the number of EFIC full-time equivalent (FTE) employees increased from 70.4 to 85.8 or by 22 per cent (for the CA and NIA). Annual staff costs per FTE employee increased from $141 000 to $179 000 or by 28 per cent (EFIC 2007–2011). This rate of increase in average staff costs per FTE employee exceeds the 15 per cent increase in the ABS labour price index (excluding bonuses) for the financial and insurance services industry between 2006-07 and 2010-11 (ABS 2011e). At public hearings, EFIC did not contest that its staff costs have increased more than its staff numbers. It identified that this is due to its recruitment of a greater number of professional staff than administrative staff resulting in a higher average salary for its staff as a whole (trans., p. 292).

In contrast, EFIC's non-staff costs (for the CA and NIA) increased by 13 per cent in the five years to 2010-11, which is equal to the general increase in prices for goods and services during the period (as measured by the ABS all groups consumer price index) (ABS 2011d).

The increase in EFIC's operating expenses has been accompanied by an increase in some of EFIC's reported output measures, including value of exports supported[1] and number of facilities (the face value of facilities signed was also slightly higher in 2010-11 than 2006-07) (figure 8.3). Although operating expenses increased in nominal terms, in terms of some outputs they decreased over the period. For example, EFIC's average operating expenses per facility signed decreased from $0.41 million to $0.24 million, and operating expenses per million dollars of exports supported decreased from approximately $11 000 to $7000.

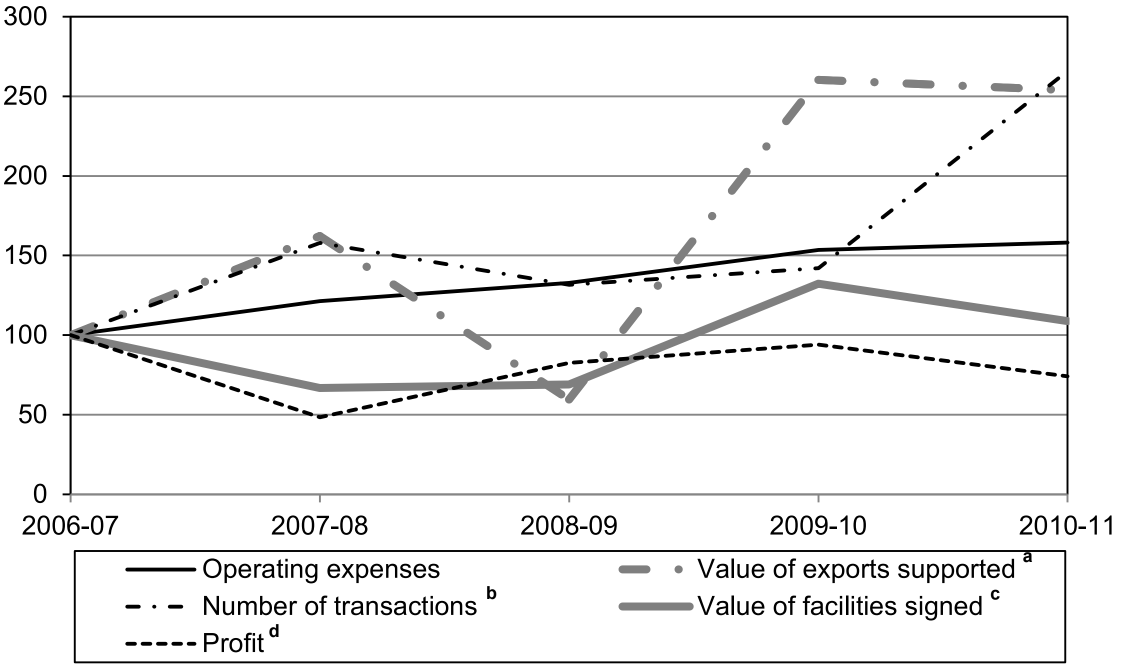
However, both the value of facilities signed and exports supported are only partial measures of EFIC's output and are not sufficient to demonstrate EFIC is becoming more efficient. For example, average expenses per facility signed could decrease

1 The Commission has previously noted there are technical difficulties with estimating the value of exports supported by EFIC (chapter 2).

without it necessarily achieving efficiency gains such as a cost reduction in its facility approval process. Other output measures on EFIC's CA, such as profit, did not increase during the period.

Figure 8.3 **EFIC's commercial account operating expenses and measures of activity and profitability**

Index, 2006-07 is equal to 100



[a] Value of exports and overseas investments supported as calculated by EFIC. There are technical difficulties in accurately calculating an estimate of Australian exports supported by EFIC. [b] Number of facilities includes facilities shared between the CA and NIA. [c] Face value of loans, guarantees, insurance and bonds. [d] Profit is the accounting profit reported by EFIC in its annual report.

Sources: EFIC (2007–2011; pers. comm., 5 December 2011).

The Commission's analysis of EFIC's operational performance is relatively simple and does not constitute an audit of EFIC's operational performance. In its draft report, the Commission requested additional information regarding EFIC's operational efficiency but none was forthcoming from participants or EFIC.

In sum

The key consideration in assessing EFIC's financial performance on the CA is whether it operates on a commercial basis and achieves a return on equity commensurate with the risk it incurs.

Although EFIC has recorded accounting profits in 19 of the past 20 years, its exemption from competitive neutrality arrangements means that its profits do not take into account the full cost of providing its products, including income tax expense, the opportunity cost of capital and lower borrowing costs arising from the Australian Government's guarantee.

As a corporation, EFIC's activities on the CA have earned a low rate of return on equity. A number of factors may be adversely affecting its financial performance:

- As demonstrated in chapter 6, not all of EFIC's transactions are priced to reflect the expected full cost given the risk incurred.
- EFIC has a high level of retained capital, which may indicate it is using its capital inefficiently.
- There has been rapid growth in EFIC's operating expenses.

An assessment of EFIC's operational efficiency will not be possible until it is subject to competitive neutrality arrangements and operates on an equal footing with private sector providers.

FINDING 8.4

The Australian Government has not received an adequate return for the risk it has incurred from EFIC's operations. This may reflect a number of factors, including that some facilities are not priced to reflect their expected full economic cost (given the risk incurred), a high level of retained capital, and possibly high operating expenses.

9 Governance arrangements

Key points

- The Export Finance and Insurance Corporation (EFIC) has some of the building blocks for a strong governance framework. However, a number of its internal processes are weak and this increases the likelihood that financial and reputational risk will be unnecessarily transferred to the Australian Government.
- EFIC's overall performance would be improved if it had a clearly defined and rigorous objective that is based on market failure, around which a performance management framework was developed.
- Transparency would be enhanced if there was greater public reporting of EFIC's activities and performance, including through the publication of its corporate plan.
- The Commission is not satisfied that the written material provided to the EFIC Board is sufficient to evaluate whether facilities submitted for Board approval on the commercial account are meeting the Minister's expectations regarding pricing, or to determine that EFIC is not competing with the private sector.
- EFIC's compliance with the *Export Finance and Insurance Corporation Act 1991* (Cwlth) and the Minister's Statement of Expectations has not had sufficient focus in independent reviews or EFIC's internal audit program over the past five years.
- External governance could be improved by the Australian Government providing greater clarity on EFIC's international obligations.
- The potential for conflicts associated with having a representative from the Australian Government on the EFIC Board could be reduced by excluding Australian Public Service personnel from the EFIC Board.
- Transparency of national interest account facilities could be enhanced by providing more information on the justification for, and performance of, these facilities.

The earlier chapters of this report have raised concerns about the Export Finance and Insurance Corporation's (EFIC's) operations, and in particular whether they are based on a suitable rationale for government intervention, namely addressing market failure affecting newly exporting small and medium-sized enterprises (SMEs). In view of these concerns, this chapter discusses the importance of appropriate governance arrangements, particularly given the inherent tensions when a commercially focused organisation is government owned. In line with the terms of reference for this inquiry, this chapter includes an assessment of EFIC's external and internal governance arrangements, including EFIC's operations against the functions of the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act), its powers and priorities, and the nature and appropriateness of the information and advice provided by EFIC to the Australian Government and the public.

9.1 The importance of good governance

The framework of rules, relationships, processes and systems in which agencies operate is known as their governance arrangements. The need for governance arrangements arises from the principal-agent problem — when the incentives of the decision-makers of an organisation do not necessarily align with those of the owners. Where incentives are not aligned, executives may make decisions that are not in the best interests of the owners and undermine the benefits of delegation. The problem is exacerbated in the case of publicly listed companies (owned by shareholders) and public sector organisations (owned by taxpayers) where ownership is diffuse.

One way of aligning the interests of owners and executives is for the owners to appoint or elect representatives (directors on a board) to oversee and advise, but not manage, operations. The appointment of a board of directors is the primary, and most important, means of aligning the Australian Government's priorities with those of EFIC's executive. Uhrig (2003) considered that 'typically, the priorities of the board should be the priorities of government as the representative of the community' (p. 42), and that the most effective way for this to occur is for the board to be given clearly defined objectives, and the full power to act, including to '"say no" to management' (p. 65).

Although the use of a board as a link between government and an agency is common in public sector organisations in Australia, this governance framework faces challenges. For example, the government is usually represented by a minister who acts on behalf of taxpayers. This makes the chain of accountabilities — from executives to boards to ministers (advised by Ministerial and departmental staff) to taxpayers — complex, and potentially dilutes accountabilities. Ministers (either directly or via their Ministerial or departmental staff) may seek to interfere with the operations of the organisation for politically motivated reasons. Moreover, the threats of takeover and bankruptcy, which impose market discipline on private sector boards and executives and an incentive to use capital efficiently, are usually absent (OECD 2005).

Decision makers in government-owned commercial entities (where public funds are at stake) may have different approaches to commercial risk than those in private sector firms, particularly with regard to activities with potentially high returns but also relatively high risk. For example, responsibilities for expenditure of public funds can lead to conservative behaviour, while government guarantees, or the ability to borrow at a lower cost than the private sector can increase risk taking (PC 2005).

These challenges highlight the need for sound governance procedures to effectively manage public sector organisations. Governance tools — such as ministerial directions, corporate plans, a statement of expectations (SoE), performance management frameworks and reports on operating activities — can be used to codify the way governance arrangements work in practice. These tools can also ensure that the agency's public policy goals are achieved efficiently and effectively, and that it is acting within its mandate and authorised powers. The quality of directors does not reduce the need for such tools.

Making these documents transparent and publicly available can also facilitate input and monitoring from non-government organisations. This can provide a perspective on policy issues that might not otherwise be available to the government and enhance the legitimacy of outcomes (Gunningham and Grabosky 2004). The role of public reporting and performance monitoring ensures the agency is accountable to Parliament, government and the public in its operations (appendix D).

9.2 EFIC's governance arrangements

EFIC is an authority constituted under the *Commonwealth Authorities and Companies Act 1997* (Cwlth) (CAC Act). Its features include it:

- being a body corporate
- being able to hold money on its own account rather than on behalf of the Australian Government
- having a governing board subject to directors' duties (or at least one director, subject to these duties) (DOFA 2005).

EFIC's governance arrangements, like those of other government-owned enterprises, can be considered as having two main aspects:

- *External governance* — the roles, relationships and distribution of powers and responsibilities between Parliament, the responsible Minister and the relevant department. These arrangements include: EFIC's legal authorisation and form; the degree of organisational separation from the responsible Minister; its decision-making powers; and its accountability to the Australian Government and Parliament. This includes scrutiny by the Australian National Audit Office (ANAO) through the annual financial statement audit and the potential for additional ANAO and Parliamentary Committee scrutiny. Ministerial directions and the Minister's SoE also form part of the agency's external governance arrangements. The SoE outlines the Minister's expectations of the Board regarding EFIC's provision of financial products and services, its pricing strategy, provision of information and compliance with international agreements (Emerson 2011).

- *Internal governance* — EFIC's organisational structure and lines of reporting, internal processes and procedures, financial and performance management practices, social and environmental responsibilities, and code of conduct. These are usually set out in internal policy documents. EFIC's key internal governance policies include a risk management framework (chapter 2) from which risk management and credit policies and procedures have been developed, and a policy for environmental and social review of transactions (section 9.6).

For governance arrangements to be effective and to ensure accountability, there needs to be a clear understanding of the interaction of, and a clear delineation between, the roles and responsibilities of the Australian Government (external governance) and the Board and management of EFIC (internal governance). In practice, this means the Australian Government should provide EFIC with a clear mandate under which to operate, a clear objective, and appropriate powers and resources. It should also ensure that there is performance reporting against EFIC's objective and, where performance is poor, take action.

The basis for EFIC's external governance arrangements is EFIC's enabling legislation, the EFIC Act. The Act, supported by regulations, determines EFIC's functions and duties, its powers, the role of the Minister, the eligibility criteria for the transactions it can enter into, who it can transact with, and the financial constraints within which it must operate, among other things. With regard to internal governance arrangements, the EFIC Board is charged with managing the organisation's affairs (EFIC Act, s. 33) and, through the preparation of a corporate plan, it must specify EFIC's strategies for achieving the objectives set down by the Australian Government, including financial targets (EFIC Act, s. 49). The Board also has responsibility for selecting, appointing and, where appropriate, removing the Managing Director, approving decisions that are beyond the delegation of the Managing Director, and holding management responsible for its performance.

The EFIC Board charter states that the Board is to review key internal governance arrangements, including managing portfolio risk, and maintaining corporate governance practices for EFIC's compliance with its external governance arrangements. The charter also states that the Board should monitor EFIC's operational and financial position and performance (EFIC 2011b).

The Department of Foreign Affairs and Trade (DFAT) was of the view that other Australian Government agencies also have a role in overseeing EFIC:

> DFAT considers that, while the Minister for Trade is responsible for administering EFIC's enabling legislation, all Commonwealth supporting agencies have a role in the sound administration and governance of EFIC and in ensuring that its obligations under the CAC Act are met. The Departments of the Treasury, Finance and Prime Minister and Cabinet should therefore have timely access to EFIC information and documents to fulfil their responsibilities and ensure whole-of-government consistency in the management of Commonwealth authorities. (sub. 19, p. 13)

If it is the case that other government agencies have a role in the sound administration and governance of EFIC, it is not clear what arrangement DFAT has put in place to facilitate this role.

9.3 Are EFIC's external governance arrangements adequate?

The principles for determining the most appropriate governance arrangements for Australian Government agencies are outlined in the document *Governance Arrangements for Australian Government Bodies* (DOFA 2005). The discussion below follows these principles.

Clarity of purpose

Clear objectives provide the purpose for the activities that an agency undertakes on the Government's behalf. They are essential for establishing priorities for the organisation and are also the basis for holding the organisation accountable for its performance.

As discussed by Uhrig (2003):

> Having a clear purpose is essential to effective governance. Organisations which do not operate with clear purpose have a limited capacity to define long-term goals and are unlikely to meet the expectations of stakeholders. For statutory authorities, a clear purpose is essential to meeting the objectives of government and the expectations and needs of the public.
>
> When a statutory authority is unsure of the expectations of government there is a risk it will operate in a manner that represents a wider mandate than its legislation may envisage, leading to inappropriate use of resources and unintended outcomes. There is

> also the risk that a statutory authority will not be undertaking operations that a Minister has anticipated, also resulting in a failure to meet expectations. (p. 59)

EFIC's primary duties are to:

- comply with directions from the Minister
- have regard to the desirability of improving and extending the range of insurance and other financial services and products available (whether from EFIC or otherwise) to persons involved, or likely to be involved, directly or indirectly, in Australian export trade
- have regard to Australia's obligations under international agreements
- provide services and products as efficiently and economically as possible (EFIC Act, s. 8).

The Minister, through the SoE, has directed EFIC to 'perform these functions only in circumstances where the credit and insurance sectors are not able or are unwilling to provide credit and insurance services to financially viable Australian export transactions or overseas projects' (Emerson 2011, p. 1). At the same time there is the expectation that 'EFIC's Commercial Account operations are to be conducted on a commercial basis' (Emerson 2011, p. 2).

The Commission considers that not all of EFIC's facilities on the commercial account (CA) have been priced to reflect the expected full economic cost, given the risk incurred (chapter 6). Furthermore, the Commission does not consider that EFIC has, at all times, limited its activities to a part of the market where the private sector is absent, and that it is likely that some of the projects for which EFIC has provided facilities would have gone ahead without EFIC's involvement (chapter 7).

The Commission considers that EFIC's overall performance would be improved if it had a clearly defined and rigorous objective directed at market failures affecting newly exporting SMEs. This would remove ambiguity about the extent to which EFIC's commercial performance should be traded off against objectives such as encouraging export trade, providing information and advice, and encouraging other financial institutions to undertake trade-related transactions. It would also resolve the issue of EFIC being required to participate only where private sector providers are not willing or able to provide financial services — while meeting the objective of providing financial services on a commercial basis.

Improved clarification of EFIC's objective would make for better internal and external governance, and would better enable the Minister to evaluate EFIC's performance. The Commission's proposed changes to EFIC's objective under the EFIC Act and its future role are discussed in chapter 10.

EFIC's legal form and financial management legislation

The Department of Finance and Deregulation's (DOFD) framework for establishing a suitable legal form is broadly consistent with the recommendations of the 2002 Uhrig Review (box 9.1). It provides for Australian Government agencies to be regulated by either the *Financial Management and Accountability Act 1997* (Cwlth) or the CAC Act, depending on each agency's purpose and the nature of its activities. Most Australian Government bodies operate as FMA agencies that are financially part of the Australian Government and receive public money that can only be spent with the authority of appropriation approved through Parliament.

Box 9.1 **The Uhrig Review and the Australian Government's response**

In 2002, the Australian Government commissioned a review of the governance arrangements of its agencies. The resulting report, known as the Uhrig Review, concluded that:

- statutory authorities would benefit from greater clarity in the definition of their purpose, direction and objectives, and that each Minister should issue a statement of expectations to statutory authorities within their portfolios. The statement would outline relevant government policies, including the Government's current objectives relevant to the authority and any expectations the Government may have on how the authority should conduct its operations
- board committees can be used to enhance the effectiveness of governing boards through detailed oversight and supervision of areas of risk critical to the entity's success. However, the board remains responsible for the overall governance of the entity
- most bodies (authorities and companies) covered by the *Commonwealth Authorities and Companies Act 1997* (Cwlth) should have a governing board (the 'board template') if they undertake predominately commercial operations. This is because a board is more likely to be given the necessary powers to govern such an authority. The role of public servants on governing boards needs to be carefully considered.

In 2004, the Government endorsed the review's recommendation that boards should only be used when they can be given full power to act, and if they are used, should not include Australian Public Service personnel. The Government also announced that it would implement the recommended governance templates and that ministers would provide agencies with a Statement of Expectations.

Sources: DOFA (2005); Uhrig (2003).

The DOFD framework outlines a number of factors to be considered when assessing whether EFIC's current legal form as a CAC Act authority is appropriate.

- The body operates commercially with the intention of making a profit, in a competitive environment, and it would be likely classified as outside the general government sector.[1]
- A governing board would provide effective governance.
- There is a clear rationale for the assets of the body not to be owned or controlled by the Commonwealth directly.
- The body requires a degree of independence from general policies of the Australian Government … (DOFA 2005, p. 24).

The framework also notes that CAC Act bodies may be best suited to activities that create financial risk for the Australian Government. The board of directors is to exercise its powers in the best interests of the body and for a proper purpose, and can help to ensure that prudent decisions are made on the resources that, as a matter of law, the body holds in its own right (DOFA 2005). The Government relies on EFIC's Board to properly govern the agency in line with its duties. The Board is the most important mechanism for ensuring that the agency is properly governed.

The Commission considers it is important that EFIC has sufficient independence to fulfil its commercial role, and sees benefit in EFIC having a merit-based, commercially-focused board to align EFIC's activities with the priorities of the Australian Government.

Independence from government

The EFIC Act articulates EFIC's powers, roles and responsibilities and is the formal source of EFIC's independence from government. The CAC Act provides a framework for the operations and governance of many Australian Government agencies and provides further guidance to EFIC. Ministers can request information and can expect to be informed by their department about issues concerning portfolio bodies. This is reiterated in the SoE through the expectation that EFIC will work closely with DFAT and provide support to prepare policy advice (Emerson 2011).

EFIC manages its financial reserves and borrowings in a framework determined by legislation and the Minister for Finance. It is able to enter into individual transactions on the CA without ministerial interference, provided it is within the

[1] The 'general government sector' comprises bodies that are primarily budget-funded, or that generally obtain their funds directly from government (DOFA 2005).

constraints stipulated in the EFIC and CAC Acts, and the transactions are consistent with ministerial directions. This independence was noted in the DFAT submission:

> All decisions about potential commercial account transactions are made by EFIC on the basis of commercial viability and market gap and without reference to prevailing government sentiment towards, or activities in, a particular sector or market. There is no expectation on the part of government that EFIC will do otherwise. (sub. 19, p. 4)

The DFAT submission went on to say:

> EFIC's exposures in [the] South Pacific, Asian and African economies potentially facilitate a range of development outcomes that align with Australia's broader foreign and security policy objectives. (sub. 19, p. 4)

It is not clear from the submission whether this comment relates to CA transactions or those on the national interest account (NIA), where these outcomes could be argued to constitute the 'national interest'. As the Commission considers it would be inappropriate for EFIC to make decisions regarding Australia's broader policy (or national interest) objectives — decisions that are properly the role of ministers — it is desirable that EFIC's decisions on the CA are made purely on a commercial basis.

Board composition

The Uhrig Review (Uhrig 2003) recommended that all statutory authorities adopt one of two governance templates — the 'board template' or an 'executive management template'. The review recommended the board template for statutory authorities that undertake predominately commercial operations, because a board is more likely to be given the necessary powers to govern such an authority. The review also considered that 'Membership of the board by the related departmental secretary is unwise unless there are specific circumstances which require it' (p. 99).

The Australian Government partly implemented the Uhrig Review recommendations with respect to EFIC's Board membership by discontinuing the practice of appointing the Secretary of the Department of Industry, Tourism and Resources to the Board, and by removing the legislated ex-officio status of the chief executive officer of Austrade from the Board. However, the Government decided to retain a Government member on the EFIC Board, and appoints DFAT's Secretary (or an alternate).

The Commission understands there are only five boards of Australian Government agencies that retain a government member and that, of these, only EFIC has a predominantly commercial purpose.[2] The then Minister decided to retain EFIC's government board member because:

- EFIC has a role in managing the NIA
- the government board member makes a contribution to country risk assessments, which form an important part of the Board's deliberations
- it is the most efficient means of ensuring EFIC's compliance with the 'market gap' mandate and ensuring that the Board's decisions are taken within the framework of a deeper understanding of the Government's foreign and trade policy objectives (SFADTLC 2006).

In its submission to the issues paper DFAT noted that:

> The inclusion of a government member on the [EFIC] Board is considered critical because of the specialised foreign and trade policy expertise that the member can bring to EFIC's management of transactions on its commercial account, as well as complex NIA transactions. (sub. 19, p. 10)

Regarding the first point, DFAT further noted that 'EFIC manages all NIA transactions as if they were on the commercial account' (sub. 19, p. 11). EFIC has a service level agreement (SLA) with DFAT detailing how the NIA is to be managed (box 9.2), so it is not clear what additional value the Government board member brings to this role.

Although country risk assessment assists EFIC in analysis of the risk of projects, it can be provided by DFAT to EFIC in other ways (at an operational rather than board level). The Commission considers this information role is not sufficient to justify retention of the Government board member. The information could be effectively conveyed through other means.

The role of the Government board member in ensuring EFIC's compliance with its mandate also appears flawed. DFAT officers would typically not possess significant commercial experience and their expertise would not normally be expected to extend to market and financial analysis. The challenge is complicated by the vagueness of the market gap mandate. Even with the new market failure mandate that the Commission proposes, it is unlikely that DFAT officials would possess the relevant economic and commercial skills.

2 These agencies are: EFIC; the Australian Reinsurance Pool Corporation; the Reserve Bank of Australia; the CSIRO; and the National Library.

Box 9.2 **Management of the national interest account**

Management of the national interest account (NIA) is based on a service level agreement (SLA) between EFIC and the Department of Foreign Affairs and Trade (DFAT). The current SLA runs from July 2011 to July 2014, and includes:

- requirements for DFAT to provide timely advice about any new information or decisions that may be relevant to EFIC's operations
- requirements for EFIC to conduct due diligence and manage its NIA operations efficiently, and in compliance with the EFIC Act and ministerial decisions
- a range of reporting, consultation and information sharing obligations between EFIC and DFAT.

Source: DFAT (sub. 19).

The notion that the Government board member ensures that EFIC's Board decisions are taken within the framework of a deeper understanding of the Government's foreign and trade policy objectives is also problematic. With regard to public servants sitting on boards, Uhrig (2003) said:

> … care should be exercised when appointing public servants to boards. In circumstances where a departmental staff member is appointed on the basis of representing the government's interests or having a 'quasi' supervision approach, conflicts of interest may arise and poor governance is likely. Through participation in decision-making, either directly or implied, the departmental representative may become an advocate for the organisation rather than contributing critical comment … Membership of the board by the related departmental secretary is unwise unless there are specific circumstances which require it. (p. 99)

The Commission shares these concerns. Given that the EFIC Board is expected to take a commercial approach, there is a risk of conflicts of interest emerging of the type envisaged by the Uhrig Review. For example, conflict may emerge between the foreign, trade and security policy objectives of the Government and DFAT, and the commercial interests of EFIC. The Commission considers EFIC's compliance with such policy objectives is more appropriately achieved by clear direction from the Minister.

This is not to say that there is no role for DFAT officials in engaging with EFIC or its Board. As stated by Uhrig (2003):

> [The concerns expressed] do not mean that departmental representatives should not attend board meetings as agreed by the chairman. No objections are raised to either staff of the entity or other public servants attending specific parts of a meeting to discuss or clarify issues with the board. (p. 99)

Where the EFIC Board considers that DFAT can usefully contribute to EFIC's understanding of foreign affairs, trade or security developments surrounding a transaction, it may be appropriate that a DFAT official be invited to present to Board meetings for the relevant agenda items and to answer questions relating to those items.

Importantly, if EFIC were engaging in transactions for reasons relating to foreign affairs or security considerations, it is not clear why these transactions would take place on the CA. As noted earlier, the CA should be used to support eligible transactions on a commercial basis and transactions made for national interest reasons should go on the NIA.

RECOMMENDATION 9.1

Consistent with the findings of the Uhrig Review, the Australian Government should amend the Export Finance and Insurance Corporation Act 1991 to exclude Australian Public Service personnel from the EFIC Board. Where the EFIC Board considers departmental advice beneficial, officials from the Department of Foreign Affairs and Trade should be invited to present to board meetings for the relevant agenda items and to answer questions relating to those items.

9.4 Are EFIC's internal governance arrangements adequate?

EFIC's Board is responsible for ensuring that EFIC complies with its legal obligations under the CAC and EFIC Acts, as well as the Minister's expectations outlined in the SoE. The Board is assisted in this regard by a number of governance committees (box 9.3).

Box 9.3 **EFIC's governance committees and compliance activities**

The Board is ultimately responsible for setting EFIC's risk appetite and tolerances, and is assisted by a number of internal committees, including:

- EFIC executive and the senior management teams — responsible at the management level for implementing the Board-approved risk management strategy and developing policies, processes, procedures and controls for identifying and managing risks in all areas of activity
- Audit Committee — responsible for overseeing all aspects of risk management and internal control, including compliance activity, the audit program, the appropriateness of accounting policies and the adequacy of financial reporting
- Credit Committee — chaired by EFIC's chief credit officer, examines credit policy and practices in relation to all exposures and potential transactions
- Risk and Compliance Committee — chaired by EFIC's compliance counsel, examines, monitors and regulates compliance risks
- Treasury Risk Review Committee — chaired by EFIC's head of treasury, examines treasury activities, limits, noteworthy transactions and current issues.

EFIC contends that the quality of its internal governance framework and procedures is reflected in:

- its unqualified financial statements
- compliance regimes including its Compliance Program that is benchmarked against Australian standards
- the results of a control culture survey performed by Deloitte in 2010, which found that EFIC's 'culture' performed well relative to other organisations.

Sources: EFIC (2011a); sub. DR90.

Information provided to the EFIC Board

The Commission is of the view that the written material currently provided to the Board would not support a robust audit program in relation to EFIC's mandate. The board papers provided to the Commission in the course of this inquiry have contained little analysis or discussion on how EFIC's potential intervention in financial markets meets EFIC's primary duties under s. 8 of the EFIC Act. For example, although EFIC is to have regard to the desirability of improving and extending the range of insurance and other financial services and products available, the board papers seen by the Commission do not discuss the likely impact of EFIC's involvement in promoting (or potentially dissuading through a crowding out effect) private sector provision.

Assessment of the market gap

The Minister requires that:

> EFIC is to manage its activities so that it does not compete directly with existing commercial sector providers of insurance, reinsurance and financial services and products which support Australian exports and foreign investment. Each transaction considered by EFIC must be assessed on this basis and information which shows that EFIC is not competing directly with existing commercial sector providers must be included in any Board paper seeking approval for a transaction. EFIC is not to compete with private sector operators as this is the basis of EFIC's current exemption from financial services and banking Competitive Neutrality legislation. (Emerson 2011, p. 2)

The Commission has been provided with market gap analysis for some facilities that have been approved by the Board. This analysis tends to involve statements that the project related to the facility would not have proceeded without EFIC's support and that other financiers have not provided sufficient support to meet the client's required level of funds. It also typically notes the need for facilities of longer tenor than the market is willing to provide and observes where there is support from other export credit agencies ECAs. In some cases, involvement of other countries' ECAs in a project, or in similar projects, is cited as providing assurance that a proposed facility is within the market gap. The discussion sometimes notes the inability or unwillingness of the private sector to provide additional debt or equity financing (EFIC, pers. comm., 25 October 2011).

The discussion of the market gap in board papers sighted by the Commission could be regarded as perfunctory. For example, in one instance, the analysis of the market gap for a project with substantial value extended to little more than four lines of text:

> … has confirmed that the [a bank letter of credit] is not adequate security to enhance [the company's] obligations for the 10-year bank finance required to fund the [project]. Consequently, EFIC and [another export credit agency] have been approached to provide credit support. Management is satisfied that the transaction falls within EFIC's market gap mandate. (EFIC, pers. comm., 12 December 2011)

When questioned about this at public hearings, the Managing Director and Chief Executive Officer (CEO) noted that the discussion in the boardroom about whether a facility falls within the market gap might be more comprehensive (trans., p. 161). However, as noted above, the Commission does not consider that the documentation of the analysis of the market gap is sufficient to support well informed decisions on whether the proposed facility is within EFIC's mandate. Nor is it sufficient to provide the information required by an internal audit to confirm EFIC's compliance against its mandate. The Board should also have information before board meetings to give due consideration to the material presented in the board papers (OECD 2004).

Another board paper appeared to be based on the fact that the bank of EFIC's client was not willing to provide finance. The paper noted that the client's bank:

> … provides general banking facilities to [the company], secured by a fixed and floating charge over the company's assets, although there is no material debt outstanding. [The company] has no other banking relationship. [The bank] is unable to satisfy the entire debt requirement and the FX hedging facilities. … [the company] has financed … on a contract by contract basis. ... We are satisfied that the proposed facility falls comfortably within the Market Gap. (EFIC, pers. comm., 12 January 2012).

Analysis of the market gap in relation to a facility provided to Greyhound Australia was described to the Commission as follows:

> The reality is that we have issued the bond currently at 100 per cent cash cover. The bank was only prepared to do that at 100 per cent cash cover [by Greyhound Australia]. … The market gap, the way we see it here, is a 100 per cent cash cover for a bond, which puts a considerable amount of working capital constraint on a company if they want to fulfil a large contract. … We are looking to release some of that cash throughout the phase of that project. That's what we're currently negotiating with the company. (trans., pp. 122-3)

The Commission considers that the analyses of the market gap in board papers is simply asserting that no other financial institution is willing to provide the financial services provided by the proponent. This is inadequate because board papers do not discuss pricing strategy or prices for comparable risk, or the premium that is being charged to encourage the private sector to fill the gap, as required by the Minister (Emerson 2011). Although the analysis sometimes notes the inability or unwillingness of the private sector to provide additional debt or equity financing, it does not assess the reasons, including whether risk is being adequately priced, or provide data that might support such a conclusion.

Given the vagueness of the market gap concept, it is not surprising that the quality of analysis by EFIC to ensure facilities are within a market gap is poor. The Commission also notes that difficulties in ensuring ECAs operate within a market gap framework are not confined to Australia. For example, a 2008 review of Export Development Canada (EDC) found 'there can be no doubt that EDC operates outside any "market gap", however defined' (International Financial Consulting 2008, p. viii).

Neither the committees that have been established as part of EFIC's internal governance arrangements, nor previous reviews of EFIC, have been given the explicit role of examining EFIC's compliance with its mandate. The Board has also not sought independent assurance that its operations are consistent with the SoE and Part 4 of the EFIC Act (EFIC, pers. comm., 25 November 2011, 6 December 2011).

The Commission considers that the Board should rectify this by including in its internal audit program independent assurance that EFIC's operations are consistent with its mandate.

FINDING 9.1

The Commission is not satisfied that the EFIC Board is provided with sufficient information in board papers to evaluate whether facilities submitted for approval on the commercial account are meeting the requirements set out in the Minister's Statement of Expectations with regard to pricing, or to determine that EFIC is not competing with the private sector.

EFIC's compliance with the operational restrictions in the Minister's Statement of Expectations and Part 4 of the Export Finance and Insurance Corporation Act 1991 has not had sufficient focus in independent reviews or EFIC's internal audit program over the past five years.

RECOMMENDATION 9.2

The Minister should amend the Statement of Expectations to require EFIC to include in its regular internal audit program an assessment of its compliance with the operational restrictions, as set out in the Statement of Expectations, any relevant directions from the Minister, and Part 4 of the Export Finance and Insurance Corporation Act 1991. Board papers should be sufficiently robust to ensure that they can be used in EFIC's internal audit program to confirm that EFIC is complying with its mandate.

EFIC's operations extend beyond addressing market failures

It has been noted elsewhere in this report that EFIC's operations have extended beyond what the Commission considers is appropriate based on market failure rationales for government intervention (chapters 5 and 7). Two examples are the support for large resource-related projects, and for suppliers to those projects, in Australia. The Commission's approach to this inquiry does not extend to an evaluation of EFIC's legal affairs and whether its current or proposed activities are lawful.

Supporting large resource-related projects in Australia

In the past few years, EFIC has increasingly focused on large resource projects, and has contributed to the financing of onshore infrastructure and resource processing projects that will be used for supporting exports, primarily commodity exports. Support for these types of projects is based on sections of the EFIC Act that allow EFIC to provide insurance contracts (s. 14), and guarantees and subsidies (s. 16) in relation to loans to Australian suppliers where the purpose of the loan is the financing of Australian export trade.

The focus of EFIC's activities to support projects of this type was noted in EFIC's 2011 annual report:

> EFIC's recent focus has been drawn to large-scale resource projects and related infrastructure in Australia and the region. The demand for debt to finance these projects is unprecedented and EFIC, together with export credit agencies from other countries, is increasingly being asked to deliver cornerstone components of the financing required because traditional sources cannot now satisfy the longer-tenor commitment requirements for such projects. (EFIC 2011a, p. 13)

EFIC has claimed that there may be an argument that s. 23 of the EFIC Act allows EFIC to provide loans to foreign-owned resources projects in Australia, such as the Ichthys project in Northern Australia. EFIC indicated that it has been selected as one of six ECAs to form what is described as a 'pathfinder group' for the Ichthys project — a US$34 billion liquefied natural gas project in northern Australia being undertaken by two large international companies: Inpex (Japan) and Total (France) (Inpex 2012). EFIC stated:

> That selection was based on our ability, effectively, to catalyse the support of those other five export credit agencies. So they wanted to provide a framework, establish it amongst the six export credit agencies that would start this process, which would then roll into the balance of the financing at which we would include a syndicated bank piece. So our function was to, effectively, negotiate the terms and the conditions of the project financing for the project. (trans., p. 146)

In relation to the Ichthys project EFIC also stated:

> … that is our intention, to pursue an approval from our board to participate in this [the provision of debt] financing … [but] it is undecided whether it will be in the form of debt or in the form of a guarantee. (trans., p. 146)

It further noted that s. 23 of the EFIC Act could be interpreted as supporting the use of a loan:

> … you would have to go to look at the EFIC Act to look at in what circumstances Section 23 operates and you would have to look at the facts surrounding the transaction itself and the transactions within the broader project as well. We have had a look at that

and we have considered whether there may be an argument that the facts would support the application of Section 23 in the use of a loan. (trans., pp. 294-5)

EFIC has not disclosed publicly or privately to the Commission the extent of its potential involvement in the Ichthys project. However, the potential to provide loans for a resource project located in Australia appears contrary to advice previously provided by EFIC to the Commission. EFIC noted in its submission to the issues paper that the provision of loan facilities is limited to the export of capital goods:

> EFIC cannot enter into loans for the export of non-capital goods including, for example, commodities and domestic infrastructure projects that support the export of commodities. This is a significant and unreasonable restraint on EFIC's ability to provide direct finance to Australian exporters of commodities and related domestic infrastructure projects. (sub. 18, appendix A, p. 33)

Supporting suppliers to resource-related projects located in Australia

EFIC has extended its involvement in onshore projects by marketing its financial services under a new initiative to serve suppliers to projects located in Australia, where the ultimate goods produced are exported but the companies receiving the facility are not exporting. EFIC considers the initiative complements other Australian Government policies that have been developed to help Australian companies participate in the resources sector, including the Resources Sector Supplier Advisory Forum (trans., p. 121) (box 2.5).

Under EFIC's initiative, suppliers 'must form an integral part of the overall resource export project' to be eligible for EFIC's support (EFIC ndd, p. 1). Eligible suppliers can apply to EFIC for bank guarantees, working capital support and longer-term finance.

EFIC's intention to provide financial services under this initiative is mentioned in the current corporate plan, which is endorsed by the Board. The corporate plan states that:

> At the same time, [the development of export focused, resource and energy related projects and associated infrastructure in Australia] will present opportunities to support participants in the 'exporting chain', including SME clients, who will be involved and primary or sub-contractors in the development of these projects. (EFIC 2011c, pp. 10-11)

EFIC described the initiative at the public hearings :

> The idea is really to support subcontracting companies with the large natural resources projects. They are generally SMEs, as you know. We've done a few others. Lean Field is another one which we supported in Queensland. More broadly we are definitely

> planning to help more SMEs if … they deliver a service that is integral to the project. (trans., p. 120).

EFIC has disclosed its approval of six facilities located in Australia since 1 July 2011, with a total face value $128 million (in addition to the three resource-related projects discussed in chapter 7 — Wiggins Island coal export terminal, the Santos LNG project in Gladstone and the Brookfield rail upgrade). EFIC confirmed at the public hearings that two facilities have been provided under the initiative this financial year, including the provision of a performance bond to Greyhound Australia (box 7.2) (trans., p. 142). There is insufficient public information available about the remaining four facilities.

According to EFIC, the 'integral' test was developed to be consistent with the EFIC Act. EFIC stated:

> We looked to section 19 of the EFIC Act and the wording in there allows us to provide bonding support for a contract or in relation to the performance of a contract that would be an export contract, in this case the export of a commodity. So it's those words 'in relation to the performance of' in the preamble that led us to develop this test of 'is this particular element or component of the transaction integral to the ultimate export contract?' (trans., p. 126)

Although facilities have been approved, EFIC stated that it is still developing the criteria that determine whether the proposed facility supports a good or service that is integral to the ultimate export. EFIC acknowledged that it is 'learning by doing' and is effectively developing the criteria as it goes along, on a case-by-case basis (trans., p. 134). EFIC did not provide written documentation to the Commission on the definition of 'integral to the ultimate export' or confirm whether the initiative will be restricted to SMEs.

When considering a proposed facility for eligibility, EFIC stated at the public hearing that it considers the 'conditions that sit around this transaction' and indicated that those conditions include whether a project — or a contract — is particularly large or involves particular investment by a firm (trans., p. 127). This would mean, for example, that a cleaning contract or catering services would not be considered by EFIC to be integral:

> I don't think a reasonable person would see that a relatively low value commodity-type transaction like cleaning or cooking or supplying bread and milk is integral to the project. (trans., p. 127)

The Commission acknowledges that the initiative is new but it does not consider that approving facilities before eligibility criteria are adequately developed is consistent with the principles of good internal governance. The provision of financial services exposes the Australian Government, and therefore the taxpayer, to risk and it is important that EFIC's facilities are approved on the basis that they meet the objective of the EFIC Act, and are consistent with the expectations of the Minister. It is not possible to know if this is the case in the absence of eligibility criteria that align with EFIC's mandate.

As discussed in chapter 7, there are also equity and efficiency considerations when EFIC provides facilities to some firms but not others. Clear, transparent and predictable eligibility criteria are important — not only for firms successful in gaining EFIC support, but also for those that are not.

Transparency and information provision

Transparency is critical to ensuring effective accountability. It is important to ensure regular reporting to ministers, the Government and the public, regarding EFIC's activities and performance. Information needs to be timely, relevant and of a high standard (PC 2005).

EFIC's management appears to rely significantly on the Government board member to communicate EFIC's activities to the Minister. EFIC's supplementary submission to this inquiry noted that:

> Government is kept regularly updated by virtue of the Government member of the Board attending EFIC Board meetings and key performance indicators are provided regularly to the Board to inform them of EFIC performance. (sub. DR90, p. 55)

During public hearings on the inquiry, EFIC's Managing Director and CEO noted that 'the government member presumably advises the Minister on these [human rights] issues' (trans., p. 115) and noted that EFIC would rely on the Government member to communicate the outcome of the policy review, through the annual report or the corporate plan, to the Minister. The Managing Director and CEO also noted that EFIC relies on its 'departmental colleagues' to pass on relevant information to the Minister when the executive briefs the Board (trans., p. 247).

The major mechanism for providing information to the public about EFIC's performance is the annual report. The report summarises EFIC's activities each year and details its financial results. Some information on its activities during the year is also published on EFIC's website. The service level agreement between DFAT and EFIC sets out reporting, consultation and information sharing obligations for NIA transactions.

EFIC's corporate plan

A further potential accountability tool is the corporate plan. The process of drawing up the plan, having it approved by the Minister, and publishing it increases the transparency and accountability of an organisation to the Minister, Parliament and the public. As the corporate plan primarily sets out an organisation's expected activities and outcomes with respect to its broad mandate in aggregate, information about specific transactions and EFIC's clients would not be expected to be contained in the corporate plan.

In its response to the draft report, EFIC noted that few agencies publish their corporate plans, and that it considered there was already information on its operations published on its website (sub. DR90). There is precedent in Australian Government agencies releasing their corporate plan — with measures taken to protect commercially sensitive information. For example, Airservices Australia provides revenue forecasts in its corporate plan, which is tabled in Parliament. These forecasts are based on assessments of airline activity that are not published.

The information published by EFIC in the annual report and website is predominantly retrospective. The Commission does not consider that this is sufficient to allow input from stakeholders, including non-government organisations and other Australian Government agencies, on EFIC's forthcoming activities.

Performance reporting

The reporting requirements prescribed under the EFIC Act relate to the information to be included in the annual report. The principal measures against which EFIC reports are:

- the value of facilities signed
- the value of exports and overseas investments supported
- the number of facilities provided
- profit on the CA
- capital adequacy ratio
- overall portfolio risk measured by weighted average portfolio risk grade (EFIC 2011a, pp. 4–5).

The value of signings and exports supported by EFIC, and the number of facilities provided, are easy to understand and collate, and demonstrate the level of activity that EFIC has been engaged in. However, they are measures of output and do not provide information about the efficiency or appropriateness of EFIC's facilities.

Capital adequacy and weighted average portfolio risk grade are indicators of an entity's ability to withstand unexpected events and credit risk, respectively. They are commonly used and widely accepted in the finance sector.

The indicators published by EFIC do not provide information on how effectively or efficiently the Board and management are meeting the objectives of the EFIC Act or the SoE. These indicators also do not provide a check against whether EFIC is fulfilling its mandate. There is no qualitative or quantitative measure of whether EFIC's facilities meet its objective of encouraging private sector providers to assist in financing exports such that EFIC is able to subsequently withdraw its support. Other measures that could inform the Government on EFIC's performance are not reported, or they are difficult to find and interpret. For example, measures of EFIC's non-performing facilities are not published regularly (although they have been included in EFIC's submission on the issues paper (sub. 18)).

As discussed earlier, the Commission considers that the governance arrangements to ensure that EFIC is meeting the Government's expectations (and in particular in relation to pricing and potential crowding out of the private sector) are insufficient. EFIC's performance against its objectives is not assessed in the internal audits, or by the audit committee on behalf of the Board. With the exception of the (infrequent) general reviews of EFIC, there are no effective mechanisms to ensure that EFIC is meeting its objectives either on an individual facility basis, or as a matter of broader strategy.

In the Commission's view, the lack of clarity in the information provided by EFIC is likely to have reduced the ability of some parts of the Government to fully understand EFIC's activities, increasing the likelihood of facilities being provided that were not in line with the Government's expectations.

FINDING 9.2

There is insufficient clarity in the information provided by EFIC to the Australian Government and the public, and this impairs EFIC's accountability.

The Commission considers a new performance management framework should be developed for EFIC with indicators based on a more clearly defined and rigorous objective for the agency (chapter 10). Reporting against the performance management framework should be included in EFIC's annual report and corporate plan. The Minister should table the corporate plan in Parliament, and in due course, the EFIC Act should be amended to require this.

To ensure EFIC's ongoing accountability, the Minister should be informed quarterly about new facilities on the CA, through reports against the corporate plan. The Minister's SoE to EFIC should reflect this.

RECOMMENDATION 9.3

The Minister should table EFIC's corporate plan in Parliament and, in due course, the Export Finance and Insurance Corporation Act 1991 should be amended to require this.

EFIC should provide quarterly progress reports to the Minister against its corporate plan, including information about facilities on the commercial account executed during that quarter.

RECOMMENDATION 9.4

The Minister should amend the Statement of Expectations to require the EFIC Board to establish a performance management framework, based on a more clearly defined and rigorous objective under the Export Finance and Insurance Corporation Act 1991, directed at market failures affecting small and medium-sized enterprises. The framework should be developed in consultation with other Australian Government agencies, and use relevant performance benchmarks and indicators for EFIC's business units, including treasury operations.

EFIC should report its performance against this framework in its annual report and corporate plan.

Compliance costs for clients

The terms of reference for this inquiry require the Commission to report on the level of compliance costs for businesses accessing EFIC's financial products. These compliance costs include the time and effort necessary to fill out applications, produce and supply documents to assist EFIC's assessment and other costs incurred such as seeking legal advice. More broadly, other considerations such as the time it takes EFIC to reach a decision on an application can also be considered a cost, as it may prevent or reduce the likelihood of completing an export transaction.

Minimising the costs involved to prospective clients, while maintaining appropriate credit application and risk assessment processes, should be an important priority for EFIC, particularly as its SME clients could find compliance costs burdensome.

Quantitative assessment of EFIC's compliance costs is difficult as the costs for each business are not readily observable, and the cost faced by each business varies. As such, it is necessary to rely on qualitative evidence such as customer satisfaction surveys and other objective assessments of EFIC's processes.

In its submission to this inquiry, NSW Trade and Investment (sub. 25) stated that it had received feedback from exporters that EFIC's application and approval process is cumbersome and the level of detail required is prohibitive. However, confidential survey results sighted by the Commission suggest that EFIC's customers do not find compliance costs particularly burdensome.

9.5 The national interest account

Under the EFIC Act, any decision about whether or not to accept a facility on the NIA is required to be taken by the Minister, although by convention Cabinet approval is sought (DFAT, sub. 19). The Minister can give EFIC approval to facilitate, or may direct, an NIA facility if it is deemed to be in the national interest to do so. The national interest is not defined in the EFIC Act and is not set out in government policy. Proposed facilities on the NIA can be initiated either by EFIC or the Government.

EFIC states that the EFIC Board typically refers a proposal for a facility to the Minister for inclusion on the NIA if there is a high degree of country or project-related risk, or if the exposure would exceed country and risk party limits for the CA, and where the project may be acceptable to the Government. EFIC states that when a proposal is referred by EFIC, it does not make a recommendation to the Minister, and only makes an assessment as it would normally do for a proposed facility on the CA. It is up to the Minister to make a judgement as to whether costs of the proposed facility are offset by national interest benefits before the transaction proceeds to Cabinet for final approval (EFIC 2008b).

When an NIA transaction is initiated (either by EFIC or the Government), the Commission understands an interdepartmental committee examines it before it is presented to the Minister for approval to be submitted to Cabinet. NIA transactions are accounted for on DFAT's balance sheet in the Budget statements and under DFAT in the statement of risks.

EFIC states that the NIA is managed in a similar way to the CA. It borrows in domestic and international capital markets to fund NIA loans and contingent liabilities, and does not separate NIA borrowings from CA borrowings. The Australian Government is responsible for the financial consequences of NIA facilities. EFIC remits the revenue from NIA facilities to the Australian Government and the Australian Government reimburses EFIC for the costs of servicing the portfolio and for any losses arising from it.

Some participants have criticised procedures surrounding the use of the NIA. For example, Jubilee Australia said:

> Jubilee Australia contends that the rationale for a National Interest Account is flawed: Australian taxpayers are told that, in their interest, Commonwealth funds are to be appropriated from the budget and used to assist a small number of Australian private corporations to win export contracts — in many cases to assist Australian companies to participate in projects considered excessively risky by private financiers. Any substantive information used to justify this decision, however, is protected by 'cabinet-in-confidence' and the validity of the decision is not open for debate even by elected members of the Federal Parliament. There are no checks and balances in this system and in an environment of minimal transparency, intended or unintended abuses of the policy can occur and go undetected. (sub. 12, p. 8)

As part of its activities, EFIC will, from time to time, be presented with opportunities that it perceives as being in the national interest. However, any decision by EFIC to support a proposal on the CA should be made separately from national interest considerations. This is in keeping with the Minister's expectation, as specified in the SoE, that 'EFIC's Commercial Account operations are to be conducted on a commercial basis, obtaining a return reflecting risks' (Emerson 2011, p. 2). Where support for a proposal is being sought on both the CA and the NIA, the CA supported component should be supported by EFIC for commercial reasons only.

The Commission considers that some NIA processes should be reformed. Before the Minister determines that facilities are to be placed on the NIA, assessment of the proposed facility should be undertaken to determine whether the proposal is the most cost-effective way of achieving the outcomes intended by the Government. When approved, the justification for NIA facilities should be clearly and publicly articulated.

RECOMMENDATION 9.5

Proposed facilities with national interest objectives should only be considered in the context of the national interest account.

The Australian Government's assessment of national interest account facilities should include analysis of whether the proposal is the most cost-effective way of achieving intended outcomes.

The Australian Government should clearly and publicly articulate the justification for a national interest account facility after it has been approved by the Minister.

Information on the performance of national interest account facilities should be collated and publicly reported by the Australian Government.

Over the medium term, there may be a case for moving responsibility for post-approval administration of the NIA from EFIC to another agency (such as the Department of Finance and Deregulation or the Treasury), or the private sector. An assessment of alternative arrangements to manage the national interest account should be included in the next independent review of EFIC to ensure they meet government objectives at least cost.

9.6 EFIC's environmental and social responsibilities

In the SoE, the Minister states:

> In effectively managing social and environmental risks relating to transactions, I expect EFIC to fully comply with the OECD Common Approaches on the Environment and Officially Supported Export Credits, the Equator Principles and any other relevant international standards. (Emerson 2011, p. 3)

The two international agreements that relate to EFIC are the OECD Common Approaches on the Environment and Officially Supported Export Credits (OECD Common Approaches) and the Equator Principles (box 2.3). A number of submissions raised concerns about the environmental and social consequences of EFIC's operations.

EFIC has developed a *Policy for Environmental and Social Review of Transactions* (EFIC 2011h) and a *Procedure for Environmental and Social Review of Transactions* (EFIC 2011i), referred to collectively as the Environmental and Social Policy and Procedure (ESPP) (appendix E has a detailed description of the ESPP). These documents are based on the OECD Common Approaches and Equator Principles, and have recently been revised in consultation with non-government organisations (EFIC 2011a). Although the agreements that EFIC must comply with can be narrow in their scope and may be relevant for only some products that EFIC provides, EFIC states that it extends the principles they embody to all facilities it considers (EFIC 2011h).

EFIC's ESPP was adopted on 17 February 2011. EFIC states that it will engage an independent expert to review the application of the ESPP within two years of the policy being adopted, and provide reports to the Board and the public (EFIC 2011h).

The type of environmental and social review that EFIC undertakes under the ESPP is determined by the type of support requested, the nature of the project associated with the facility and the role of EFIC's client (EFIC 2011i). EFIC undertakes an environmental and social risk evaluation of all proposed facilities and discloses its potential involvement in new projects that are considered to have potentially significant adverse environmental and social impacts (known as category A projects, consistent with guidelines under the OECD Common Approaches and Equator Principles). EFIC also maintains an archive register that publicly discloses its potential involvement in all category A projects, whether the project was supported or not. EFIC adopts a different procedure for review of proposed facilities that involve existing projects, 'non-projects' and bonds (appendix E).

EFIC has discretion to impose contractual terms on its clients as a condition of approval such as:

- requirements for additional work
- compliance with environmental and social standards
- monitoring and reporting requirements
- requirements for auditing by independent environmental and/or social experts (EFIC 2011h).

Comments from participants on EFIC's environmental and social performance

Environmental and human rights organisations have criticised EFIC and ECAs more generally for using government subsidised trade finance to support industries in developing countries that may be environmentally unsustainable or have adverse human rights impacts, and for contributing to the 'unpayable debt' of developing countries by lending to their governments (box 9.4).

A concern raised during this inquiry is the limited disclosure required by EFIC's ESPP. Some participants are of the view that there is limited transparency in the classification of projects with adverse environmental or social risks, EFIC's rationale for approving projects, and the application and adherence to conditions of approval. That is, they are classified as 'commercial-in-confidence' by EFIC and, therefore, are not able to be disclosed.

Participants also expressed concern that ECAs gave insufficient attention to human rights considerations in the policy and procedures. The Human Rights Law Centre noted that inadequate assessment of human rights can 'have moral, reputational and political consequences for the ECA' (sub. 13, p. 17) and, consequently, for the Australian Government. It also noted that delays to projects, and, therefore, increased financial exposure, could result from adverse human rights outcomes (sub. 13).

Another problem participants identified is the lack of a grievance mechanism. The current process does not allow stakeholders to have submissions considered during the classification process or at any point for category B projects (which may have adverse social or environmental impacts), or for non-projects or existing projects with adverse social or environmental impacts.

Box 9.4 **Concerns raised by environmental and human rights organisations**

Issues raised by non-government organisations include:

- EFIC's consideration of the investor's responsibilities relating to environmental and social risks and the investor's ability to mitigate risks as part of the classification procedure (Jubilee Australia, sub. 12)
- the impact of publicly funded projects on the environment. Greenpeace Australia suggested that:

  > Throughout 2001–09, the oil, gas and mining sectors accounted for over a quarter of EFIC financing … Given the urgency of global ecological concerns such as biodiversity loss, ecosystem decline and climate change, the question must be asked; why is the Australian government allowing EFIC to provide publicly backed … financial services to the industries that are most responsible for climate change and global ecological decline? (Greenpeace Australia, sub. 9, p. 2)

- that EFIC may have been involved in projects with adverse human rights impacts (Human Rights Law Centre, sub. 13)
- limited transparency of environmental or social risks and management of these risks (Jubilee Australia, sub. 12)
- absence of a satisfactory contestability mechanism, to allow stakeholders to object to decisions (Oxfam Australia, sub. 15).

Assessment of potential environmental and social impacts

Risks faced by EFIC — including reputational risk — are ultimately borne by the Australian Government. To ensure any risk to the Australian Government is avoided or mitigated, it is important that EFIC's obligations under international agreements are expressed clearly to EFIC by the Australian Government, and that EFIC meets these obligations.

The SoE outlines some of the international obligations that the Minister expects EFIC to adhere to, but references to 'other relevant international standards' and 'other international commitments' may not provide EFIC with sufficient clarity on the international obligations that it is required to comply with. However, the Minister's expectations are clear in relation to the OECD Common Approaches and the Equator Principles: EFIC is expected to be in full compliance, and the ESPP claims to extend these principles to all transactions EFIC considers (EFIC 2011h).

Disclosure and classification

Transparency is an important aspect of the OECD Common Approaches and the Equator Principles. Transparent reporting and disclosure allows examination of the activities of government agencies, and can assist in managing reputational risk to the Australian Government. The OECD Common Approaches (OECD 2007) state:

> … taking into account the competitive context in which they operate and constraints of business confidentiality, Members should … make available to the public at least annually, subject to legal provisions on public disclosure in Members' countries, information on projects classified in category A and category B, including environmental information, for which a member has made a final commitment with respect to providing official support. (p. 7)

Disclosure of prospective involvement

There are a number of exceptions to disclosure of prospective involvement in transactions with potential environmental and social effects. For example, EFIC's policy is to not disclose potential involvement in new projects that have been classified as category B[3], or category A projects that:

- are located in Australia
- have a repayment term of less than two years
- are valued at less than $15 million unless they are in sensitive areas such as national parks.

EFIC's ESPP includes an assessment of the potential environmental and social impacts of non-projects (that is where a proposed facility is not associated with an identified location) and bonds. However, EFIC is not required to disclose

3 Projects that fall between category A and category C (table E.1).

prospective involvement in 'non-projects' and bonds that have *significant* potential environmental or social impacts. EFIC states this is because these proposed facilities are not associated with a particular location or operation (for example, equipment manufacture where the equipment will have many different purchasers or users). EFIC states that the client, and therefore EFIC, cannot usually 'access environmental and social information' and has 'no influence on the environmental and/or social management of the project for which the export is destined' (EFIC 2011h, p. 4).

However, any facility that is linked to activity with significant environmental and social impacts may result in reputational risk to the Australian Government. Stakeholder engagement in the decision making process would allow input from Australian Government agencies and non-government organisations that may reduce the likelihood of reputational risk to the Australian Government from EFIC's support of such a facility.

In its submission to the draft report, EFIC noted that:

> Issuance of bonds is typically time sensitive and delays associated with disclosure periods could render Australian exporters uncompetitive. (sub. DR90, p. 60)

The Commission considers that reputational risk to the Australian Government should not be overridden by commercial imperatives, including delays due to disclosure periods.

EFIC notes that its approach to classification and disclosure of non-projects and existing projects, and projects valued at less than $15 million is in accordance with the OECD Common Approaches. However, EFIC's statement that it extends the 'principles they [the OECD Common Approaches and the Equator Principles] embody to all transactions it considers' (EFIC 2011i, p. 3) is weakened by the various exceptions it applies to the general principle contained in the OECD Common Approaches. That principle is to 'foster transparency, predictability and responsibility in decision making by encouraging disclosure of relevant environmental information' (OECD 2007, p. 3).

Classification of proposed facilities

A number of stakeholders also considered EFIC's environmental and social classification of proposed facilities as being controversial. EFIC's classification of a proposed facility determines whether disclosure of prospective involvement is required. EFIC classified some projects as category B that stakeholders thought should have been classified as category A, including:

- the construction of an ammonium nitrate plant in Indonesia in 2010 (Ludlam 2011)
- the sale of contract mining services to a gold mine in Ghana in 2010 (Jubilee Australia, sub. 12).

Senator Conroy (Senate 2011) said, in response to a question on notice, that the classification of a gold mine in Ghana as category B was taken following an assessment by EFIC, including a review of publicly available information on its client's customer. That review indicated that the project had been assessed and funded by the commercial arm of the World Bank, the International Finance Corporation (IFC). The IFC financing of the project was subject to the mine operator meeting stringent environmental and social standards, with ongoing monitoring and reporting in place (including assessments by independent consultants) (Ludlam 2011). There had been a number of controversies associated with the mine prior to EFIC's involvement in 2010, including a cyanide spill in 2009 (Jubilee Australia, sub. 12).

The Commission considers that although risk mitigation practices by project operators, and the role of EFIC's client in risk mitigation, are relevant to the final decision as to whether to provide a facility, they should not be a factor in determining the type of environmental and social assessment that EFIC undertakes, or the classification of the proposed facility.

Disclosure of assessments

Under the ESPP, EFIC does not release environmental and social information contained in impact assessments it considers are commercial-in-confidence and not required to be disclosed under EFIC's statutory confidentiality obligations (EFIC 2011h). There is also limited transparency as to how environmental and social risks are factored into decisions to approve facilities.

EFIC also does not disclose contractual conditions that may apply on an individual transaction basis. This makes it difficult to determine whether EFIC is actively encouraging the mitigation of adverse environmental and social impacts of new or existing projects, and the client's performance against such terms.

In its response to the draft report, EFIC noted that:

> The publication by EFIC of information that is confidential to a client (whether it be 'financial' or otherwise) would inevitability undermine the confidence EFIC's clients and counterparties have that EFIC is able to keep information confidential (sub. DR90, p. 66)

As mentioned earlier in this chapter, transparency and publicly available information can facilitate input and monitoring from non-government organisations, provide a perspective on policy issues that might not otherwise be available to the government and enhance the legitimacy of outcomes. Transparency and public reporting of information that is not commercial in nature can improve accountability to Parliament, government and the public. Section 9.7 has further discussion of disclosure issues.

FINDING 9.3

Increased public disclosure of information relevant to environmental and social impact assessments, including contractual terms to manage and mitigate risk, would enhance the transparency of EFIC's operations to the public and to the Australian Government.

RECOMMENDATION 9.6

The Minister should amend the Statement of Expectations to require EFIC to publicly disclose its prospective involvement in any facility with potentially significant environmental or social impacts. This includes all category A projects, and 'non-projects' and bonds where it has been determined that there is potential for significant environmental and social impacts.

Information relating to the environmental and social classification of projects and the reasons for their approval should be predictable and disclosed in the annual report and on EFIC's website. This information should include assessment benchmarking and processes, conditions of approval and consequences for non-compliance. Information that is relevant to EFIC's assessment of environmental and social impacts should be made public.

EFIC should make public its involvement in supporting projects that are subject to environmental assessment in Australia.

Measures to mitigate against bribery of public officials

Bribery of foreign public officials is a crime under the *Criminal Code Act 1995*. As a member of the Export Credits Group (ECG) of the OECD, EFIC states that it complies with the OECD Council Recommendation on Bribery and Officially Supported Export Credits (OECD 2006a). It is also a member of the local chapter of Transparency International (EFIC ndb). The international regulatory framework and EFIC's anti-bribery and corruption measures are discussed in appendix E.

The OECD Council Recommendation outlines measures to be undertaken by ECG members to deter and combat bribery in connection with officially supported export credits. These obligations include:

- informing clients of the legal consequences of engaging in bribery in international business transactions
- encouraging clients to develop, apply and document appropriate management control systems that combat bribery
- requiring clients to provide an undertaking that they, or anyone acting on their behalf, will not engage in bribery in the transaction
- informing the law enforcement authorities and refusing to provide credit or other support for a transaction if there is credible evidence that bribery was involved in the award or execution of an export contract. (EFIC ndb, OECD 2006a).

During the course of this inquiry, two of EFIC's clients were the subject of Australian Federal Police investigations for alleged bribery in relation to projects that have also received EFIC support (box 9.5).

Human rights

The Department of Foreign Affairs and Trade noted that Australia co-sponsored the resolution endorsing the UN Guiding Principles on Business and Human Rights (known as the Ruggie Principles) in June 2011. It also notes that Australia is a signatory to the International Convention on Economic, Social and Cultural Rights. However, Australia has not taken a formal position on the policy statement from the forty-sixth session of the Committee on Economic, Social and Cultural Rights. Further, Australia has not taken a formal position on the Maastricht Principles on Extraterritorial Obligations of States in the area of Economic, Social and Cultural Rights, which were adopted on 28 September 2011 (DFAT, pers. comm., 23 January 2012).

It is important to have clarity on which international obligations EFIC is required to adhere to, particularly as these obligations are likely to change over time. As noted above, references in the SoE to 'other relevant international standards' and 'other international commitments' are unlikely to provide EFIC with sufficient clarity on the international obligations that it is required to comply with.

Box 9.5 **EFIC's support for Leighton Offshore and Tenix**

EFIC provided two performance bonds, together worth US$36.7 million to enable Leighton Offshore (a subsidiary of Leighton Holdings) to provide enhanced oil export facilities to the state-owned South Oil Company in southern Iraq. The bonds were issued in 2010 under a bonding line provided by EFIC to Leighton Holdings, that is available to companies in the Leighton Group for projects undertaken worldwide.

On 7 November 2011, Leighton Holdings reported to the Australian Federal Police (AFP) possible payments made by Leighton Offshore to a foreign public official in connection with oil contracts in Iraq for two major oil construction projects worth $1.2 billion. The AFP and an anti-corruption unit inside the Iraqi Oil Ministry have commenced investigations into the allegations. The matter is under investigation and the alleged payments have not been confirmed.

EFIC stated in a response to a question taken on notice during Senate Estimates hearings on 16 February 2012 that a review of all facilities related to the Leighton Group was conducted in December 2010 prior to the issuing of performance bonds, and more recently in January 2012 as part of an annual client review process. EFIC stated that it uses a proprietary external service that searches databases to identify information on the background of its clients that may include information relating to bribery and corruption. EFIC also stated that its annual review focused on information from this report, but did not specifically focus on the Leighton Group's published Code of Ethics. EFIC did not state when the Code of Ethics was last examined (DFAT 2012).

During the public hearings on this inquiry, EFIC indicated that it did not have any reasonable grounds for concern in regards to the conduct of Leighton Holdings or the South Oil Company prior to the announcement of the AFP investigation.

In 2001-02, EFIC provided a $109.9 million export finance guarantee to Tenix Defence, an Australian military contractor, to provide six search-and-rescue vessels to the Philippines Coast guard. The guarantee enabled the Philippines Government to borrow from banks to finance the contract. Tenix is currently being investigated by the AFP in response to alleged bribery in its business conduct in Asia, including the contract in the Philippines. EFIC's support for the Tenix contract was provided prior to the signing of the OECD Recommendation on Bribery and Officially Supported Export Credits in 2006 and the establishment of EFIC's current Environmental and Social Policy and Procedure. Information pertaining to any current debt owed by the Philippines Government, including the amount that remains outstanding, has not been publicly disclosed by EFIC.

Sources: Armour (2012); EFIC (2002); Leighton Holdings (2012).

During public hearings on the inquiry, Jubilee Australia noted the absence of direction to business and agencies from the Australian Government in relation to the Ruggie Framework:

> That's the missing piece here, is the messaging and the leadership from the Australian Government in setting the standards for EFIC and for EFIC's clients to comply with. (trans., p. 101)

In its submission to the draft report, EFIC argued that the Government articulating all of its international human rights obligations in a general direction would not provide any information that is not currently available on the Australian Treaties Database on DFAT's website. In addition, EFIC stated that it uses a variety of sources as part of its due diligence process for examining human rights issues, including the IFC Performance Standards, the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles for Business and Human Rights and its participation in the OECD Export Credit Group and the Equator Principles working groups (sub. DR90).

The Commission notes that the Australian Treaties Database includes hundreds of treaties, including 50 relating to human rights. It is not clear to the Commission how, using this approach, EFIC is able to identify which obligations apply to its operations and how it ensures it is complying with these obligations.

The Commission considers it important that ministerial directions should articulate precisely which international obligations EFIC is required to comply with, and that compliance with those obligations should be part of EFIC's internal audit program and publicly reported.

RECOMMENDATION 9.7

The Minister, by way of a direction under the Export Finance and Insurance Corporation Act 1991, should articulate which international obligations, including human rights obligations, EFIC is required to comply with.

EFIC's compliance with those obligations should be included in its internal audit program with outcomes publicly reported, including in EFIC's annual report.

9.7 Confidentiality and disclosure issues

As discussed in chapter 2, the *Freedom of Information Act 1982* (Cwlth) (FoI Act) provides exemptions for EFIC in relation to documents concerning anything done by it under Part 4 or 5 of the EFIC Act (that is, in relation to insurance and financial services and national interest transactions).

EFIC is also subject to secrecy requirements under s. 87 of the EFIC Act that prevents outside communication of information relating to the affairs of EFIC's clients (although this information may be disclosed to the Minister, or the Secretary, or a designated officer of DFAT). However, the s. 87 provisions are limited and, as noted by DFAT, the EFIC Act explicitly 'does not prevent EFIC publishing particulars about guarantees, contracts or loans made or proposed to be made under the Act' (sub. 19, p. 13).

The FoI Act exemptions reduce the ability of the public and the Australian Parliament to examine facilities for their environmental, social and human rights impacts. EFIC has stated that the FoI exemption is justified as it ensures commercially sensitive information is provided to EFIC:

> The disclosure or tabling of confidential information would inevitably undermine the confidence that EFIC's counterparties have that EFIC is able to keep information confidential. These parties rely on EFIC's obligations under the EFIC Act and FOI Act and without the reassurance of this protection information may be withheld, which would restrict EFIC's capacity to assess, monitor and manage risk with important implications for project outcomes and potential financial losses for EFIC and ultimately the Government. (sub. 18, appendix A, p. 43)

However, a number of submissions have raised doubts about whether confidentiality provisions are appropriate. For example, Greenpeace Australia noted:

> Information on the levels of public risk, the environmental considerations and deliberations made in financing decisions, the nature of the ecological information relied [upon] in making decisions are all examples of information that is of legitimate public interest. (sub. 9, p. 4)

And Jubilee Australia said that it:

> … is in full agreement with EFIC that documents such as financial statements and cash flows of client companies should be kept confidential. We ... also … [agree] that there is a distinction between commercial information and information pertaining to social and environmental issues. Yet neither in the policies nor the practices of EFIC is this distinction clear. 'Commercial-in-confidence' is not defined and no Disclosure Policy exists. (sub. 12, p. 13)

Following a visit to Australia in 2011, Dr Cephas Lumina, the UN Independent Expert on foreign debt and human rights also expressed concern about EFIC's disclosure policies:

> … the Independent Expert fully supports the view that the absence of transparency requirements raises serious questions about the agency's accountability to Australian taxpayers and to citizens of the developing countries where it supports projects. Loans underwritten by the Government of Australia or guaranteed by the Governments of the

> countries where EFIC-supported projects are being implemented are matters of public concern. Consequently, he is of the view that EFIC should be required to publicly disclose information concerning its activities, including project assessment, decision-making and implementation and to undertake assessments of the human rights impact of its financing decisions (in addition to its environmental and social impact assessments). In particular, the Government of Australia should ensure that the activities of EFIC are fully compliant with Australia's international human rights obligations. (Lumina 2011, p. 12)

In response to a question on the costs to EFIC of improving its disclosure practices, Jubilee Australia noted during the public hearings:

> I think that it's justified, the cost, if there is a cost. I think that there is an imbalance. I think issues are lurking in the shadows that need to be brought out. I don't think that these broad sweeping protections are necessary. They hide … issues and circumstances that the Australian taxpayers and the Australian Government needs to be looking at (trans., pp. 101-2).

The costs of publicly releasing material that may compromise a firm's commercial advantage must ultimately be weighed against the reputational risks to the Australian Government of supporting projects with potential significant environmental and social impacts. As public sector entities have stewardship of public funds, they are subject to different forms of operational accountability than private sector entities. The requirement for such transparency could reasonably be thought of as a cost of dealing with a government-owned entity.

If EFIC were subject to the FoI Act, exemption provisions under the legislation would apply to information in its possession, including those related to Cabinet and commercial-in-confidence material. This would maintain the confidentiality of EFIC's client's commercially valuable information while also providing scope for enhanced transparency of EFIC's operations on the CA.

RECOMMENDATION 9.8

The Australian Government should remove EFIC's special exemption in relation to matters done under Parts 4 and 5 of the Export Finance and Insurance Corporation Act 1991 from the Freedom of Information Act 1982 (while retaining protection for Cabinet and commercial-in-confidence material).

9.8 In sum

EFIC has some of the building blocks for a strong governance framework, such as a merit-based board with members who have experience in managing financial institutions. However, some of EFIC's internal governance processes are weak and would be improved with the implementation of the Commission’s recommendations.

EFIC’s business activities are extending in scope. It has recently focused on large, resource-related projects located in Australia. The Commission has found that facilities to support suppliers to onshore resource-related projects have been approved in the absence of adequate eligibility criteria to determine whether the good or service provided is integral to the ultimate export.

As discussed in chapter 8 some aspects of EFIC’s credit risk management have not been sufficiently robust, and it is important that EFIC’s governance arrangements provide confidence that the Australian Government will not be unnecessarily exposed to financial risk.

Decision making is typically improved by having better information available. Poor transparency and low levels of stakeholder engagement in EFIC’s decision making increases the likelihood that EFIC will not successfully mitigate the environmental, social and reputational risks.

The Commission considers governance practices, including EFIC’s internal audit program, are not sufficient to ensure EFIC’s activities are consistent with the operational restrictions set out in the SoE and Part 4 of the EFIC Act. Further, there is also a lack of clarity in the information provided by EFIC to the Australian Government, and to the public, and this impairs EFIC’s accountability.

10 A future role for EFIC: limited support for SMEs

Key points

- The Commission considers that, until it is next reviewed by an independent body, EFIC's mandate and operations on the commercial account (CA) should be reoriented to address information-related failures in financial markets that impede access by newly exporting small and medium-sized enterprises (SMEs) to export finance.
- EFIC's role on the CA should be to demonstrate to the private sector that providing export finance to newly exporting SMEs can be commercially viable.
- To be effective in this demonstration role, EFIC should:
  - charge a price covering the expected full economic cost of provision
  - be subject to competitive neutrality arrangements including earning an appropriately benchmarked rate of return on equity, setting prices that are commensurate with the level of risk incurred, and paying a tax-equivalent charge and a debt neutrality fee
  - publish information on the facilities it approves on the CA, including the name of the firm, price and other terms of provision.
- EFIC's CA product range should be limited to guarantees and bonds, including the provision of bonds on behalf of the exporter. When directed by the Minister, the product range may include the provision of reinsurance, for a limited period, to cover country and sovereign risk insurance provided to SMEs by the private sector. Assistance on the CA is only to be provided in respect of export contracts.
- The Commission has found no convincing evidence to indicate there are failures in financial markets that impede access to debt or equity finance for large firms, or for resource and infrastructure projects located in Australia. EFIC should not continue to provide financial services to large corporate clients or for domestic resource-related projects on the CA.
- Under the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act), EFIC is able to support projects and firms that are increasingly remote from the export focus of the Act. This increases the risk that EFIC will provide financial services to firms that do not require assistance, or to less efficient firms that do.
- The Australian Government should not broaden the eligibility criteria under Part 4 of the EFIC Act. In particular, the Act should not be amended to enable EFIC to provide loans on the CA involving export transactions for non-capital goods.

This report has highlighted a number of issues with the way the Export Finance and Insurance Corporation (EFIC) is currently operating, and detailed a number of recommendations on how aspects of its operations could be improved. This chapter discusses the Commission's views on a future role for EFIC.

10.1 Changing EFIC's scope of operations

The scope of EFIC's operations has evolved since it was established in its current form in 1991. For example, the short-term insurance arm of EFIC's origination business was divested in 2003, new products have been developed, such as the Producer Offset loan, and EFIC has recently focused on supporting resource projects and related infrastructure located in Australia on the commercial account (CA). EFIC's operations in 2011-12 have expanded to include support for suppliers to resource-related projects in Australia.

The 2006 review of EFIC considered the scope of EFIC's operations and canvassed options to amend Part 4 of the *Export Finance and Insurance Corporation Act 1991* (Cwlth) (EFIC Act), discussed below. In its submission to this inquiry, EFIC highlighted some areas of the EFIC Act that it considers unnecessarily constrains its scope and flexibility to support Australian exports.

Exporters and private sector providers have identified further scope to expand EFIC's operations. For example, in discussing EFIC's role during the current European debt crisis, Austal stated:

> In this regard, Austal considers that there is substantial opportunity to enhance the role that EFIC plays in these difficult economic times to support Australian manufacturing jobs. Austal would like to see EFIC's role broadened to … include the direct funding of transactions, residual value of financing, direct asset ownership and leasing/chartering of vessels to clients. (sub. 27, p. 2)

Other participants to this inquiry noted that there may be opportunities for EFIC to expand its operations. The Australian Institute of Export, for example, noted there is a need for EFIC to provide greater support to the small exporters who have strong potential for growth, and that the EFIC Act should be broadened to include a wider range of goods and services (sub. 4). The Construction, Forestry, Mining and Energy Union expressed a similar sentiment suggesting that amendments may be made to enable:

> EFIC [to] fund new businesses with one type of support (taking equity for instance and selling it down over time) and more established business with another (traditional methods of export facilitation provided by EFIC). (sub. 10, p. 2)

Proposals to expand EFIC's operations should be considered in the same way as EFIC's current operations — on the basis of a market failure rationale for government intervention.

The following sections present the Commission's views on the various paths for expanding the scope of EFIC's operations that have either been taken by EFIC in recent years or have been proposed by participants to this inquiry. These include:

- EFIC's support for resource-related and infrastructure projects located in Australia
- EFIC's ability to provide loans for non-capital goods
- EFIC's ability to support overseas investment by Australian firms
- the size of EFIC's capital base.

Support for resource-related projects located in Australia

As discussed in previous chapters, EFIC has recently extended its operations to provide financial services to firms undertaking resource-related projects in Australia and to domestic suppliers of goods and services to those projects.

This expansion of EFIC's operations has occurred pursuant to sections 7 and 8 of the EFIC Act that allow EFIC to support persons 'indirectly' involved in Australian export trade, and the eligibility criteria in section 3 of the Act that allows support for export, or export related, transactions that meet one of the criteria below:

- eligible export transaction
- export contract
- carrying on Australian export trade
- overseas investment transaction.

These provisions are problematic, because they are very broad, conceivably covering any transaction in the supply chain. They create the risk of EFIC supporting projects and firms that are increasingly remote from the original export focus of the EFIC Act and from the market failures affecting exporters' access to finance or insurance. As discussed in chapter 7, the Commission did not find compelling evidence of market failure affecting availability of finance for infrastructure and resource projects located in Australia and associated export supply chains. The Commission also notes that government assistance is potentially available to these firms through other programs (discussed in chapter 2). There is a risk that EFIC, through its expansion into those areas, will provide assistance to those that do not require it or to less efficient firms that do, while acquiring the focus and characteristics of an investment bank. The Commission has discussed the risks and potential costs associated with governments owning banks in chapter 4.

These provisions can also be a source of considerable uncertainty over EFIC's mandate. In public consultation with the Commission, EFIC did not provide evidence of adequate eligibility criteria to determine when a particular transaction should be within or outside of its scope of operations.

The Commission considers that the EFIC Act should be amended to remove all references to EFIC providing support on the CA to those indirectly involved in Australian export trade, and to constrain the eligibility criteria to transactions based on an export contract. A direction to this effect from the Minister would be warranted, pending the legislative amendment. This would improve certainty for EFIC and its potential clients, discourage firms indirectly involved in export transactions from seeking assistance, and refocus EFIC toward meeting its objective of facilitating and encouraging Australian export trade.

Loans for non-capital goods

In its submission to the issues paper, EFIC (sub. 18, appendix A) noted that the current eligibility criteria for loans restrict EFIC to lending for the purposes of financing an 'eligible export transaction' (EFIC Act, s. 23). The definition of eligible export transaction in the EFIC Act includes capital goods, the provision of services related to the export of capital goods produced in Australia or the provision of construction, technological, managerial or other services in another country. In that submission, EFIC claimed it was unable to make loans for non-capital goods including commodities and argued it was:

> … a significant and unreasonable restraint on EFIC's ability to provide direct finance to Australian exporters of commodities and related domestic infrastructure projects. (sub. 18, appendix A, p. 33)

As discussed in chapter 9, EFIC has subsequently claimed to have received legal advice that section 23 of the EFIC Act gives it the power to provide loans to companies undertaking the Ichthys project — a US$34 billion liquefied natural gas project in northern Australia being undertaken by a consortium of foreign oil and gas companies.[1]

1 At the time of writing this report, no decision had been taken by the EFIC Board as to whether EFIC would provide debt or a guarantee to the Ichthys project but discussions have taken place on EFIC's support.

As noted, the Commission has not found convincing evidence to indicate there are failures in financial markets that impede access to debt or equity finance for large firms, or for domestic resource projects and related infrastructure. Furthermore, as discussed below in a more general context, the Commission does not support EFIC performing a direct lending role on the CA. Consequently, the Commission does not support the proposed amendment to the EFIC Act to enable EFIC to support loans for non-capital goods on the CA, nor does the Commission support EFIC relying on the existing provisions of the Act to this effect.

Support for overseas investment

The 2006 review of EFIC noted that EFIC had proposed to improve small and medium-sized enterprises' (SMEs) access to financial services when expanding their supply and distribution chains overseas. The review stated that consultations with exporters and industry groups highlighted that exporting had moved away from a 'produce and ship model', and that changes to the eligibility criteria under the EFIC Act were needed to support offshore investment.

In May 2007, the then Minister for Trade announced that EFIC's powers on the CA would be expanded to provide for a broader eligibility test to enable support for SMEs seeking to expand globally (Truss 2007). In 2009, the then Minister for Trade announced that the Australian Government would simplify and expand EFIC's powers so it could more effectively provide financial support by streamlining the eligibility criteria (Crean 2009a). The proposed new arrangements were to involve a 'net economic benefits test' and would allow SMEs to establish global supply and distribution chains, and reduce the cost burden of accessing EFIC's services. This change would enable EFIC to take account of factors such as financial returns to the company (in the form of dividend income and other revenue) and increased overseas market access when determining eligibility for support. It would enable EFIC to provide increased support for Australian firms making investments overseas.

However, while the Commission has identified potential information-related failures that may affect the access to finance and insurance by newly exporting SMEs, it remains to be seen whether EFIC is able to resolve those in a way that generates a net benefit to the community. It would be imprudent to expand the scope of EFIC's operations before this question is answered empirically. Therefore, the Commission does not support this amendment to the EFIC Act at this time.

EFIC's capital base

At 30 June 2011, EFIC's capital base was about $408 million of paid-in equity and retained earnings. In the 2012-13 Budget, the Australian Government made an allowance for a special dividend of $200 million to be paid from EFIC's capital and reserves (Australian Government 2012).

In its submission to this inquiry made before the Budget announcement, EFIC observed:

> EFIC is constrained by the size of its balance sheet and capital base from supporting larger transactions over A$100-150 million. This inability to provide large sums curtails EFIC's ability to support large export transactions. Without EFIC's backing, Australian exporters may be disadvantaged as a foreign buyer may direct its procurement plans elsewhere. (sub. 18, appendix A, p. 33)

In the Commission's view, the only area where government intervention through EFIC may be warranted concerns newly exporting SMEs. In that context, EFIC noted that:

> EFIC has sufficient capital to service a number of SME transactions. (sub. 18, appendix A, p. 33)

The Commission also proposes that this intervention will be more limited than currently, due to the adoption of more restrictive criteria for defining an SME.

In sum

The Commission considers that neither the expansion of the scope of EFIC's operations through amendments to the EFIC Act proposed by EFIC, nor EFIC's recent expansion into supporting resource-related projects located in Australia and their suppliers, are justified on market failure grounds. Therefore, the Commission recommends that EFIC's support for resource-related projects located in Australia should cease, and there should be no further broadening of EFIC's activities. In particular:

- EFIC should be given a direction by the Minister to cease support for transactions that are not based on an export contract.
- The Australian Government should not proceed with a broadening of the eligibility criteria under Part 4 of the EFIC Act. Specifically, the EFIC Act should not be amended to:
  - give EFIC additional powers to support offshore investment
  - allow EFIC to enter into loans for the export of non-capital goods.

RECOMMENDATION 10.1

As soon as possible, the Minister should direct EFIC to cease providing financial services for transactions that are not based on an export contract as defined in section 3 of the Export Finance and Insurance Corporation Act 1991 (EFIC Act). This includes resource projects located in Australia, and related infrastructure, and suppliers of goods and services to those projects.

The Australian Government should not broaden the eligibility criteria under Part 4 of the EFIC Act. Specifically, the EFIC Act should not be amended to allow EFIC to enter into loans for the export of non-capital goods.

10.2 Structural and operational reform of EFIC

It is the Commission's view that a number of changes should be made to EFIC's mandate and operations to ensure its CA activities align with a market failure rationale for government intervention. These changes seek to improve EFIC's governance arrangements and ensure that it offers export finance products to newly exporting SMEs on a commercial basis, that is, the price for EFIC's financial services should cover the expected full economic costs of provision.

A more clearly defined objective

The Commission has concluded that there may be information-related market failures affecting access to export finance and insurance by newly exporting SMEs. EFIC's CA objective should be to address these market failures. EFIC's role should be to demonstrate to the private sector that providing export finance to newly exporting SMEs can be commercially viable. This role is consistent with EFIC's function under section 7(b) of the EFIC Act:

> … to encourage banks, and other financial institutions, carrying on business in Australia to finance, or assist in financing, export contracts or eligible export transactions …

In order to perform this role, it is important that EFIC generates reliable and relevant information that is disseminated to market participants. It is essential that EFIC operates on the same basis as the private sector — with price covering expected full cost of provision. This should be underpinned by removing EFIC's exemptions from competitive neutrality arrangements. This will not only improve EFIC's incentives to provide financial services more efficiently, it will also improve the incentives of those who use EFIC's financial services. EFIC's services will be demanded when it is more efficient — from an economy-wide perspective — to do so.

As a matter of good governance, the scope of EFIC's operations should be regularly reviewed, internally through its audit program, and independently, for consistency with its mandate.

RECOMMENDATION 10.2

Until it is next reviewed by an independent body, EFIC's role on the commercial account should be limited to demonstrating to the private sector that providing export finance to newly exporting small and medium-sized enterprises (SMEs) can be commercially viable. This demonstration role should be articulated in the Minister's Statement of Expectations.

EFIC should demonstrate that the provision of financial services to newly exporting SMEs can be done on the same basis as the private sector — with price covering the expected full economic cost of provision.

Changes to the product scope

The financial products and services offered by EFIC should address the source of any market failure in the most direct way possible, and generally be the minimum necessary to facilitate the efficient functioning of the market. Some of the products offered by EFIC are rarely used by its clients because they are widely available from private sector providers or there are preferred alternatives. For example, EFIC acknowledged in its submission that 'political risk insurance represents a small and infrequent portion of EFIC's business' (sub. 18, appendix A, p. 29).

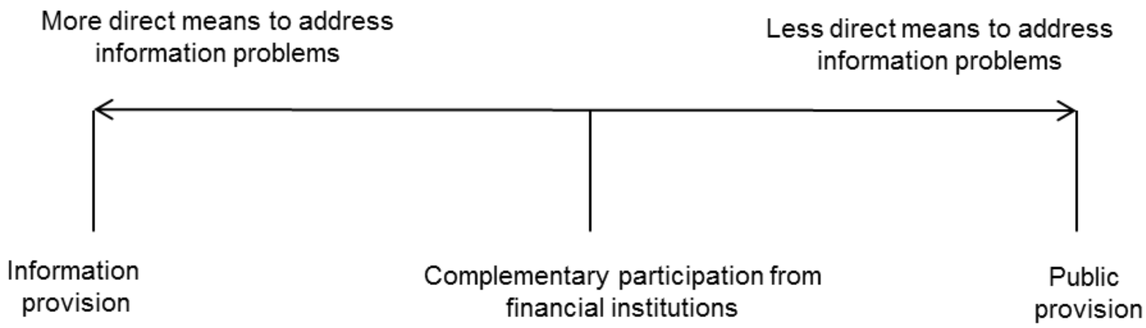
Some of EFIC's other products may not be matched to a policy problem. For example, EFIC's Producer Offset loan brings forward payment of a government rebate for film production. EFIC justified retaining this product by stating:

> Due to the small size of the transaction and the high level of documentation involved, it would be difficult and unnecessarily costly for EFIC to provide guarantees to commercial lenders to support these transactions. (sub. DR90, p. 76)

However, the Commission does not consider EFIC's involvement in the Producer Offset scheme is necessary at all. As discussed in chapter 3, this product is available from several private and public sector providers. More importantly, to the extent that there is any inefficiency associated with accessing the Producer Offset scheme, it is best to address it through the effective design of that program, rather than through EFIC.

More broadly, where the inefficiencies arise out of information problems, the most direct and least distortionary way of addressing them is through providing the information to market participants. At the other end of the spectrum is full public provision of finance and insurance that displaces any actual or potential participation by private sector providers. Between the two extremes are financial and insurance products, which by their nature require complementary participation by a financial institution (figure 10.1). For example, provision of a guarantee by EFIC presupposes the involvement of a financial institution to provide a product such as a loan.

Figure 10.1 **Alignment of government action with information problems affecting access to export finance and insurance**



As outlined in chapter 3, EFIC provides a range of export finance and insurance products. These products can be classified into one of the categories below (table 10.1).

To the extent that the dissemination of information may not be a cost-effective or practical approach to addressing the information-related problems that affect access to export finance and insurance, there are several compelling reasons for limiting the scope of EFIC's products to those that require the involvement of private sector providers.

First, this approach limits the scope for EFIC to crowd out the private sector, with operations limited to areas in which the private sector may underprovide financial services due to information-related market failures. Second, where private sector providers have cost advantages in delivery (both by virtue of their size and a stronger profit maximising motive), this approach would capitalise on those advantages.

Third, facilities that require participation of another financial institution are a more direct way of generating a demonstration effect and facilitating future private sector involvement. This approach will also generate useful information on private sector capacity and could inform decisions on whether government presence is still warranted.

Table 10.1 **Classifying EFIC's products and services**

Information dissemination	*Complementary provision*	*Full public provision*
Export Finance Navigator	Export finance guarantee	Direct buyer finance
Country profiles	Documentary credit guarantees	Direct exporter finance
World Risk Developments	Working capital guarantee	Producer Offset loan
Economics chartpack	Foreign exchange facility guarantee	Contract bond insurance
Global Readiness Index	Reinsurance	Bond insurance
	Advance payment, performance and warranty bonds that are provided by the client's bank and guaranteed by EFIC	Insurance to cover sovereign and country risk
	US bonding line	Credit insurance
		Advance payment, performance and warranty bonds that are provided directly by EFIC to the buyer

In the United Kingdom, a divestment of the short-term insurance arm of the Export Credit Guarantee Department (ECGD) was preceded by the agency limiting its services to reinsurance for private providers. The subsequent lack of demand for such reinsurance provided the evidence that private sector capacity was sufficient and future government involvement was no longer warranted (NERA 2000).

In an economic analysis of the US Export-Import Bank, Baron (1983) assessed the rationale for government provision of export finance and argued that even where it was warranted, direct lending would exceed the minimum required to resolve the market failure. Baron concluded that loans were an inferior option to loan guarantees and insurance. Similarly, Ascari (2007) argued that provision of guarantees limited the risk of crowding out other participants because the product still requires an underlying loan from the private sector.

In its response to the Commission's draft report, EFIC noted that in the majority of cases it operated by providing guarantees. However, it argued that the approach of limiting its scope to just that type of product was flawed:

> This rigid approach reduces the ability of EFIC to structure flexible responses to the increasingly complex demands of exporters. (sub. DR90, p. 77)

It further claimed:

> The evidence from the GFC is that a guarantee only model has a fundamental weakness in a credit crisis … ECAs that provide only guarantees and insurance have been struggling to establish funding vehicles in the context of a credit market collapse. (sub. DR90, pp. 77-78)

However, as discussed in chapter 5, the Commission considers that those arguments are not grounded in a sound rationale for government intervention. While it is important that EFIC's ability to generate a benefit for its client base is not unduly compromised, the underlying and more important objective is targeting the potential market failures affecting private sector provision of finance and insurance. As noted, fluctuations in the global supply of finance, in and of themselves, are not a sound rationale for intervention, nor is supporting exports as an end goal likely to maximise the net benefit to the community as a whole.

In future, the Commission considers that EFIC's product range should be limited to guarantees and bonds, that fall within the definition of a 'guarantee' in section 3 of the EFIC Act. This includes the provision of bonds on behalf of the exporter. In times of significant market disruption, and subject to ministerial direction, there may be a case to temporarily include the provision of reinsurance in the product range to cover sovereign and country risk insurance provided by the private sector.

RECOMMENDATION 10.3

In respect of the commercial account, the Australian Government should make amendments to the Export Finance and Insurance Corporation Act 1991 (EFIC Act) to:

- ***reorient EFIC's objective to addressing information-related market failures in financial markets affecting newly exporting small and medium-sized enterprises (SMEs) seeking access to export finance***
- ***specify that EFIC is to demonstrate to the private sector that providing export finance to newly exporting SMEs can be commercially viable***
- ***clarify that assistance is only to be provided in respect of export contracts as currently defined in the EFIC Act***
- ***remove references to EFIC providing support to persons indirectly involved in Australian export trade***
- ***limit the financial products offered by EFIC to guarantees and bonds falling within the definition of 'guarantee' under section 3 of the EFIC Act***
- ***allow for the product range to include the provision of reinsurance cover for sovereign and country risk insurance provided by the private sector in times of disruption in particular markets, subject to ministerial direction.***

Limiting the number of facilities provided to EFIC's clients

Several of EFIC's clients have been provided with many facilities. This repeat business is inconsistent with EFIC effectively pursuing a demonstration role for private sector providers and locks in the status quo in the export finance and insurance markets. It reduces the incentives of exporters to find alternative sources of finance or alter their business practices, and can discourage the private sector from developing the requisite capacity to assist newly exporting SMEs.

There is a strong case to establish a limit on the number of facilities to be provided to the same client on the CA. In its draft report, the Commission proposed a limit of three, with subsequent facilities requiring approval by the EFIC Board and notification to the Minister. EFIC and several of its clients disagreed with this recommendation (box 10.1).

Box 10.1 **Some participant views on the limit of three facilities per client**

- EFIC may assist the same firm in one market more than once. If the firm's transaction bank supports the bulk of the firm's activity with the exception of one market, it will be more efficient for EFIC to provide support than the firm to experience switching costs. EFIC may assist the same firm in more than one market. If the 'market gap' is perceptions of risk in different markets (e.g. five different emerging and frontier markets), or funding issues (e.g. large infrastructure projects or the export of high-value capital goods), there could be demand for EFIC's support. (EFIC, sub. DR90, p. 79)
- We are concerned that the Productivity Commission report has recommended EFIC should not support companies more than 3 times … The arbitrary limit does not take into account such things as the possibility of new markets, new products, new services, different EFIC products available now or in the future … (Synertec, sub. DR43, p. 2)
- What is the rationale for stopping at three transactions? If there is an information gap for 3 transactions, there is likely to be the same gap for 10, 20 or 103 transactions. Such a gap does not suddenly disappear after 3 transactions. (Whittle Consulting, sub. DR60, p. 3)
- … certain industry sectors have a greater need (eg shipbuilding where the asset is literally 'floating') and industry confidence will not be sustained on the back of 'we'll support your first sales and then you are on your own'. If the private sector had appetite for these transactions they would be there on day one. (Export Council of Australia, sub. DR107, p. 3)

The Commission disagrees with participants that argued that EFIC should continue to provide support *until* it is available from private sector providers on terms suitable to the exporter (and by implication, provide it indefinitely, if no private sector support is forthcoming). As discussed in previous chapters, absence of private sector support could indicate appropriate commercial decisions on the risks and expected returns of the project. The Commission also disagrees with the argument that continued support is warranted to avoid the cost of switching to another provider. As discussed in chapter 7, the costs of switching to another bank are not a market failure and continued support on this basis is likely to entrench the status quo and be inefficient in the long run.

However, the Commission acknowledges that a blanket approach may not be optimal in all cases. It also agrees that the potential information-related failures are not limited to the risks specific to the newly exporting SME. As discussed in chapter 5, the second area where information problems may prevent commercially viable export transactions relates to country risks in emerging export markets.

The Commission has revised its recommendation to take the above considerations into account. It considers that a limit of three facilities per client should normally apply. However, there should be some scope to exceed the limit, while still generating a demonstration effect. Proposals to exceed the limit of three facilities should be subject to one of the two conditions below:

- the export transaction is in an emerging export market or
- the facility has been explicitly approved by the EFIC Board (and not by a delegate), is notified to the Minister and is included in EFIC's internal audit program and independent review of EFIC's operations.

The limit should not apply to political risk reinsurance facilities provided pursuant to the direction by the Minister.

RECOMMENDATION 10.4

A limit of three facilities per client should normally apply to EFIC's future operations on the commercial account. Proposals to exceed this limit should be subject to at least one of the two conditions below:

- ***the export transaction is in an emerging export market or***
- ***the facility has been explicitly approved by the EFIC Board (and not by a delegate), is notified to the Minister and is included in EFIC's internal audit program and independent review of EFIC's operations.***

The limit of three facilities should not apply to political risk reinsurance facilities provided pursuant to the direction by the Minister.

The need for greater transparency on commercial matters

A key condition for EFIC to successfully perform a demonstration role is that its activities are transparent. In the Commission's view, the current arrangements are not conducive to performing that role.

EFIC does not publish information on its pricing for particular facilities. Several other Export Credit Agencies (ECAs), including those of Germany and Denmark provide some guidance on their pricing in the form of online calculators. Under the *Freedom of Information Act 1982* (Cwlth) all documents relating to anything done by EFIC under Part 4 (Insurance and Financial Services and Products) of the EFIC Act are exempt from disclosure.

Within a month of execution, EFIC should publish information on the facilities it approves on the CA, including the name of the firm, price and other terms of provision. This would facilitate the pursuit of three objectives:

- It would demonstrate to private sector providers where EFIC is placed in the market and possibly highlight some commercial opportunities.
- It would reduce the transaction costs for EFIC's potential clients and private sector providers.
- It would impose pricing discipline on EFIC and discourage strategic behaviour by potential clients to obtain support on subsidised terms.

In its submission to the draft report, EFIC (sub. DR90) argued against disclosing information on the price and terms of its facilities, on the following grounds:

- EFIC's clients have a reasonable expectation of client confidentiality — disclosing the prices of the facilities indicates a credit judgement by EFIC and could have adverse consequences for its clients.
- The disclosure would not achieve its objectives, because the information would not be useful for market participants due to:
  - EFIC's pricing being affected by information not related to the exporter, such as the buyer's credit worthiness and country of origin
  - the bespoke nature of the facilities.

The Commission is not proposing that the broader financial details of the applicant are made public, rather only information that relates to the facility. The Commission does not expect that the publication of this information would generate a significant impost for EFIC's clients, and it has not received any evidence in submissions from EFIC's clients to indicate otherwise. For example, Marine Western Australia indicated that such disclosure would not be a concern for its members (trans., p. 21) and Greyhound Australia (sub. DR59) supported the recommendation. Furthermore, to the extent that EFIC's clients are aware of the disclosure requirements prior to obtaining the facility, this would form part of their consideration on whether to obtain it. Consequently, only the facilities for which the benefits of disclosure outweigh the costs will be provided.

The Commission also disagrees that disclosure will not generate useful information. First, as discussed by the Commission, information-related market failures are not necessarily limited to the exporter and could include the buyer's country. Thus, even where EFIC's pricing primarily reflects the risks relating to the buyer's country, it could still be addressing an information-related market failure. Second, while individual facilities may be bespoke in nature, their demonstration value should not be assessed in isolation. The information published by EFIC relating to facilities for a particular importing country, type of export or exporter should be considered in aggregate and as such, would have demonstration value. For example, the Australian Centre for Renewable Energy stated:

> ACRE agrees with [the] recommendation … and believes that the publication of transactions executed by EFIC would be an important measure to correct the information failure which currently exists with financiers and investors considering renewable energy projects. (sub. DR115, p. 2)

RECOMMENDATION 10.5

EFIC should publish information on the facilities it approves on the commercial account within a month of execution, including the name of the firm, price and other terms of provision.

A move to another form of provision?

The Commission has also given consideration to whether a different model of provision would be more appropriate, drawing on the experience of other ECAs. The similarities and differences between the approaches of other ECAs are discussed in appendix C.

ECAs around the world broadly fall into three institutional models, namely the:

- departmental model
- state-owned corporation or agency model
- private company as agent model (Wang et al. 2005) (table 10.2).

Departmental model

The setting up of ECAs as government departments is relatively rare in OECD countries. The United Kingdom's ECGD is an example of this model, with the ECGD responsible to the Secretary of State for Business, Innovation and Skills.

ECAs set up under a departmental model are typically less structurally independent than those constituted under an arm's length state-owned corporation or agency model. However, depending on prevailing governance arrangements, departmental agencies might be more accountable to the government and Parliament.

The departmental model is likely to be more appropriate when an agency is predominantly pursuing non-commercial objectives on behalf of government. Where agencies are largely commercial in their operations, there are likely to be benefits from providing them with greater independence and placing them on a more commercial footing. Thus, the Commission considers that the departmental model is not suitable for the role proposed for EFIC.

Table 10.2 **Selected ECAs: institutional models and product offerings**

			Key product offerings		
ECA	*Country*	*Institutional model*	*Loans*	*Insurance*	*Bonds and guarantees*
EFIC	Australia	State-owned	✓	✓	✓
ECGD	United Kingdom	Departmental		✓	✓
US Ex-Im	United States	State owned	✓	✓	✓
NZECO	New Zealand	State owned		✓	✓
Coface	France	Private		✓	
Euler Hermes	Germany	Private		✓	✓
Atradius	Netherlands	Private		✓	✓
EDC	Canada	State-owned	✓	✓	✓
JBIC	Japan	State-owned	✓		✓
NEXI	Japan	State-owned		✓	✓
Sinosure	China	State-owned		✓	✓
China Ex-Im	China	State-owned	✓		✓

Sources: Berne Union (2011); ECA websites.

State-owned corporation or agency model

The state-owned corporation or agency model is the most commonly employed for ECAs, and includes agencies such as EFIC, the Ex-Im Bank in the United States and the New Zealand Export Credit Office (NZECO). This model puts agencies at arm's length from government, providing them with greater autonomy and making them less vulnerable to political intervention by ministers.

Among those ECAs constituted under this model, there are varying arrangements incorporating differing degrees of independence. The Ex-Im Bank in the United States is constituted as an independent agency by Congress, with appointments to the Board made by the US President after congressional advice and consent. The NZECO is set up as a business unit within NZ Treasury, with the Secretary of Treasury approving all transactions after advice from technical advisers and an independent agent (namely EKN, Sweden's ECA, appointed after a contestable process). This level of oversight could help to ensure funds are wisely spent.

However, the involvement of a senior departmental official who reports to a minister, and must take into account the views and instructions of a minister in decisions about individual transactions, has the potential to reduce ECA independence. That said, legislative measures to prevent ministers intervening in individual transactions could go some way to dealing with this potential problem — such arrangements are common in other areas of public administration where senior department officials have some statutory decision-making powers.

Where the objectives of an ECA are largely commercial, the state-owned agency model is likely to be most appropriate as it allows ECAs to pursue those objectives relatively free of political constraints. However, for the model to operate effectively, it is important to have effective governance arrangements. Governance arrangements for EFIC are described, and improvements proposed, in chapter 9.

Private company as agent model

While most ECAs are government owned, the governments of some countries have entered into arrangements with private companies to fulfil the ECA role. Examples of such arrangements include Coface in France, Euler Hermes in Germany and Atradius in the Netherlands. Under these arrangements, the companies perform the initial risk analysis and transact on the government account. Where the private company is acting as an agent for the government, all risks remain with the government (Wang et al. 2005). A similar approach, but one where the commercial risks would not remain with the government, involves the private provider receiving a subsidy from the government to undertake transactions on its own account.

Where private firms are used, there could be efficiency gains and benefits from independence, although these are not guaranteed (and the latter would depend heavily on governance arrangements). However, there is also potential for higher transaction costs and conflicts of interest between the government and private company involved. Under the model, governments would still provide direction with regard to the ECA's overall direction and priorities.

It is also unclear how this approach would overcome the potential market failure identified by the Commission. To the extent that the government has an informational advantage over the private sector in assessing the risks associated with particular transactions, this approach would not utilise it. The Commission considers that its recommendation on limiting EFIC's product scope to products that require private sector participation strikes a better balance between capturing any informational advantages associated with government involvement and the efficiencies associated with private sector provision.

A move away from provision of finance and insurance — the case for direct provision of information

An alternative to provision of finance and insurance as a means of conveying information to market participants is for EFIC to provide the information it has directly to the market. As discussed in chapters 2 and 5, there are several state and Australian Government programs aimed at addressing the various information problems potentially faced by exporters. In this scenario, EFIC would operate similarly, while addressing the specific problems affecting the access to finance and insurance of newly exporting SMEs. A variant of this approach involves rolling the function of addressing any information problems affecting export finance and insurance markets into one of the existing Australian Government programs. For example, moving this function to Austrade could generate administrative synergies, although these may be limited, if as claimed by EFIC (sub. 18) and the Department of Foreign Affairs and Trade (sub. 19), the functions performed by EFIC and Austrade are complementary and there is little overlap.

However, the approach of addressing potential information problems through pure information provision faces some practical challenges that would limit its effectiveness. First, it may not be possible to disclose some of the information utilised by EFIC in its assessments due to the sensitive nature of the information.

Second, this information may not be as credible to market participants as that generated from direct involvement in the provision of finance or insurance. There is a stronger incentive for EFIC to ensure the information it signals to the market is correct where it is the provider of finance and insurance, due to the financial consequences to EFIC of making a mistake. As noted by NERA (2000), potential investors and financiers are more likely to believe government claims about creditworthiness if the government backs its claims with financial resources.

In summary, the Commission considers that at this time greater gains can be made by focusing on the recommended reforms to EFIC's mandate, operations and governance, rather than through adopting a different model of delivery of export finance and insurance or a shift to direct information provision.

Summary of the Commission's proposals

The Commission's analysis indicates that EFIC's operations on the CA at present are poorly directed and inequitable. EFIC's current CA mandate is inefficient, vaguely defined and has not been subject to adequate internal or external oversight. A focus on the so-called 'market gap' has meant that EFIC has not targeted its operations to address market failures, but rather to areas that should be the domain of the private sector. EFIC's pricing and project selection criteria distort the allocation of resources within the trade finance sector and within the economy, and these distortions would be magnified with any expansion of EFIC's CA operations.

The Commission has concluded that EFIC's CA operations need to be significantly reformed to reduce the likelihood that financial and reputational risk is unnecessarily transferred to the Australian Government, and ultimately, taxpayers. The reforms to EFIC's mandate and operations recommended in this report seek to reorient EFIC's activities to address information-related market failures confronting newly exporting SMEs and to improve EFIC's governance arrangements. The Commission acknowledges the advice from EFIC that the Commission's proposed model for EFIC would make it unique among the world's ECAs. However, the Commission's assessment is grounded in assessing the rationale for intervention and determining the best policy response.

Finally, the proposed reforms to EFIC's mandate will be testing for EFIC. However, if it is the case that information-related market failures are impeding access to finance by newly exporting SMEs, over time private sector providers will see opportunities in this market segment if EFIC is able to demonstrate that these failures are preventing commercially viable export transactions. If demand for EFIC's services gradually declines over time as a consequence, this should be seen as a policy success. If on the other hand, EFIC struggles to develop a sustainable business, this would be evidence that either the market failures of concern are not extensive or that they are not amenable to being addressed through the direct provision of financial services by EFIC. These matters would need to be considered in an independent review of EFIC.

The Commission's reform proposals outlined in this and the previous chapters are summarised in table 10.3.

Table 10.3 **Selected features of current and proposed arrangements**
EFIC's activities on the commercial account

	Current arrangements	*Proposed arrangements*
Objective	Facilitate and encourage Australian export trade Operate in the market gap	Address potential information-related market failures affecting newly exporting small and medium-sized enterprises' (SME) access to export finance
Policy mechanism	Provision of export finance and insurance that is not always priced on a commercial basis	Demonstrating to the private sector that providing export finance to exporting SMEs can be commercially viable Transparent and limited provision of export finance to SMEs, reflecting expected full economic cost
Governance	Insufficient internal and independent oversight of compliance with mandate	Internal audit program and independent review of compliance with mandate Improved transparency through publication of corporate plan
	Reporting arrangements that are inadequate to assess EFIC's performance	Reporting against a performance management framework reflecting the clearly defined, rigorous objective. More frequent reporting to the Minister Independent review against the new limited mandate three years after revised Statement of Expectations or legislative amendments have passed
Scope and focus	Predominant focus on large corporate clients, and resource-related projects in Australia	Focus on newly exporting SMEs A direction from the Minister to cease support for resource projects located in Australia, and related infrastructure, and suppliers to those projects
	Broad range of products overlapping with those offered by the private sector	Product range limited to guarantees and bonds, including the provision of bonds on behalf of exporters
	No limits on the number of facilities per client. Often repeat clients	Normally three facilities per client. Proposals beyond the three facility limit should either relate to an emerging export market, or require approval by the Board, be notified to the Minister and be included in EFIC's internal audit program and independent review
	Support can include provision of facilities for transactions indirectly related to Australian export trade	Transactions limited to those based on an export contract
	Relationships with financial institutions beyond demonstration role	Engagement with financial institutions based on demonstrating commercial viability through transparency in pricing, facing the expected full economic cost of provision
Operational outcomes	Low rate of return on equity	Return on equity appropriately benchmarked
	The price of some facilities is not sufficient to cover expected full economic costs	Pricing that reflects the expected full economic cost of the product or service, underpinned by compliance with competitive neutrality arrangements
	Strategic conduct by clients	Low incentive for strategic conduct by clients due to appropriate pricing, transparency and increased disclosure requirements
	Misallocation of resources that impose an efficiency cost on the Australian economy	Private sector provision of export finance to newly exporting SMEs achieved through a demonstration effect

10.3 Next steps

Mechanics of reform

Some of the reforms to EFIC's mandate, structure and operations proposed in this report require amendments to the EFIC Act, although initially many of the reforms can be instituted through the Statement of Expectations, and a ministerial direction. The Commission considers that, where possible, the changes should not wait for legislative amendments to be passed by Parliament but that having the measures clearly specified in the Act would ultimately be prudent.

Sections 9(2) and 9(3) of the EFIC Act provide a mechanism for the Minister to issue broad directions to EFIC on the performance of its functions:

> 9(2) The Minister may give written directions to EFIC with respect to the performance of its functions or the exercise of its powers if the Minister is satisfied that it is desirable in the public interest that the directions be given.
>
> (3) EFIC must comply with any direction under subsection (2).

The Commission notes that this power is limited by section 9(5) which states:

> 9(5) Subsection (2) is not intended to authorise a direction:
>
> (a) requiring the Minister's approval of the entry by EFIC into a particular contract or the giving by EFIC of a particular guarantee or the making of a particular loan; or
>
> (b) giving the Minister power to determine that EFIC is or is not to enter into a particular contract, give a particular guarantee or make a particular loan.

However, the Commission considers that its recommendations are broader in scope than directions that apply to a particular transaction and, therefore, would not fall under s. 9(5).

The Commission recommends that — pending legislative amendment where it is required — the proposed changes should, where possible, be directed by the Minister in the form of a ministerial direction or revised Statement of Expectations (table 10.4).

RECOMMENDATION 10.6

Where possible, the Minister should give effect to the proposed changes to EFIC's operations through a ministerial direction or a revised Statement of Expectations, until such time as the Export Finance and Insurance Corporation Act 1991 can be amended.

Table 10.4 **Possible mechanics of reform**

Recommendation		Implementation instrument			
		MD[a]	*SoE*	*EFIC Act*	*Other*
Mandate					
7.1	Market gap mandate to be discarded		✓		
10.2 10.3	Objective changed to addressing information failures for newly exporting SMEs via demonstration effect for the private sector		✓	✓	
10.1 10.3	EFIC to cease supporting projects not based on an export contract and persons indirectly involved in exporting	✓		✓	
Scope of operations					
5.1	SMEs defined as entities with annual turnover of $50 million or fewer than 100 employees		✓		
10.3	Product range limited to guarantees and, subject to ministerial direction, political risk reinsurance	✓		✓	
10.4	Limit on the number of facilities per client		✓		
Pricing of products and services					
6.2	EFIC required to price its facilities at expected full economic cost and achieve an appropriately benchmarked rate of return		✓		
	Exemption from competitive neutrality arrangement removed; report revenue relating to tax-equivalent charge and debt neutrality fee pending amendment of EFIC Act		✓	✓	
6.1	Process for allocating risk scores to be independently reviewed		✓		
10.5	EFIC to disclose price and terms of its facilities		✓	✓	
Financial performance and risk management					
8.1	EFIC to set a limit on particular industry exposures				✓
8.2	Size and scope of EFIC's treasury to be reviewed by The Treasury and the Department of Finance and Deregulation				✓
8.3	EFIC Act to be amended to allow the Minister to direct the Board to return surplus capital			✓	
Governance					
9.1	EFIC's Board not to have Australian Public Service members			✓	
9.2	EFIC's compliance with operational restrictions to be included in the internal audit program		✓		
9.3	Corporate plan to be tabled; EFIC to report quarterly against it		✓	✓	
9.4	Performance management framework; reporting of performance in annual report and corporate plan.			✓	
Social and environmental obligations					
9.6	Public disclosure of involvement in projects with potentially significant environmental or social impacts		✓		
9.7	EFIC's international obligations clarified by the Minister; compliance subject to internal audit program	✓			
9.8	EFIC's exemption from FOI to be removed			✓	✓
National interest account					
9.5	National interest objectives only considered in the context of NIA		✓		
	NIA proposals to be assessed on cost effectiveness against alternatives; justification for approval made public				✓
	Information on performance of facilities to be published by the Australian Government				✓

[a] Ministerial direction under section 9 of the EFIC Act.

Future review of EFIC

EFIC should operate under this mandate until it is next reviewed by an independent body. Its performance against the objective of addressing information-related failures in financial markets affecting newly exporting SMEs should be independently reviewed three years after a revised SoE is issued by the Minister or the amendments to the EFIC Act have been passed by Parliament, whichever occurs first. At this time, there should be sufficient information available to form a more definitive view of the extent of any market failures affecting newly exporting SMEs. Based on this view, the independent review should consider whether the rationale for government intervention remains valid, and whether the provision of export finance and insurance through EFIC is the most effective and efficient way of addressing any failures in financial markets that are impeding otherwise commercially viable export transactions. The review should also include examination of alternative arrangements for post-approval administration of the national interest account to ensure current arrangements meet government objectives at least cost.

RECOMMENDATION 10.7

EFIC's performance against the more clearly defined and rigorous objective should be independently reviewed three years after a revised Statement of Expectations is issued by the Minister or the amendments to the Export Finance and Insurance Corporation Act 1991 have been passed by Parliament, whichever occurs first.

This independent review should consider whether the rationale for government intervention remains valid, and whether the provision of financial services through EFIC is the most effective and efficient way of addressing any failures in financial markets that are impeding otherwise commercially viable export transactions. This review should also include examination of alternative arrangements for post-approval administration of the national interest account.

A Conduct of the inquiry

Outlined in this appendix are details relating to consultations through:

- submissions received (table A.1)
- visits (table A.2)
- public hearings (table A.3).

The Commission received the terms of reference for this inquiry on 1 September 2011. Following receipt of the terms of reference, the Commission placed notices in the press and on its website inviting public participation in the inquiry. Information about the inquiry was also circulated to people and organisations likely to have an interest in it. The Commission released an issues paper on 7 October 2011 to assist inquiry participants with preparing their submissions. The Commission received a total of 116 submissions.

Public hearings were held in Perth, Sydney and Canberra in March and an additional hearing was held in Sydney in April, which together attracted 17 participants.

The Commission has conducted meetings with a range of organisations, individuals, financial institutions, industry bodies and government agencies.

Table A.1 **Submissions received**

Individual or organisation	*Submission number*
Airport Support Industries	DR28
Allens Arthur Robinson	DR42
Almondco	DR36
ANZ	20, DR101
Asian Development Bank	2
Ausenco Limited	DR86
Austal Limited	27, DR110
Australian Trade Commission	14
Australian Centre for Renewable Energy	22, DR115
Australian Chamber of Commerce and Industry	5, DR106
Australian Industry Group	23, DR98
Australian Institute of Export	4, DR107
Australian Manufacturing Workers Union	DR111
Australian Rural Exports Pty Ltd	7*, DR74*
Australian Services Roundtable	21, DR114
Bothar Boring & Tunnelling	DR73*
Bronx International Pty Ltd	DR81
Brookfield	DR102
Business SA	6
Chartis	DR89
Citibank	DR108
Clifford Chance	DR52
Clough	DR104*
Codan Ltd	DR65
Commonwealth Bank of Australia	DR100
Construction Forestry Mining and Energy Union of Australia	10
Consult Australia	DR109
Contrarian Tax Unit Pty Ltd	DR57
Credit Agricole CIB	DR75
Department of Agriculture and Food (WA)	16
Department of Foreign Affairs and Trade	19
Deutsche Bank AG	DR38
Downer EDI Limited	DR40
Dragonet Films	DR33
E W Cox International Pty Ltd	DR69
Eco-kinetics	DR61
Emtivac Engineering Pty Ltd	DR77
Environmental Systems & Services Pty Ltd	11
Export Finance and Insurance Corporation	18[#],DR90
Ferra Engineering Pty Ltd	8

(Continued next page)

Table A.1 (continued)

Individual or organisation	*Submission number*
Freehills	DR70*
Frosty Boy Australia	DR80
Gasco Pty Ltd	DR82
General Electric	DR116
Goalpost Pictures Australia	DR30
GP Graders	DR35
Greenpeace	9
Greyhound Australia	DR59
GRM International Pty Ltd	DR85*
Gulf Industrials	DR113*
Hanseatic Marine	26*
Human Rights Law Centre	13, DR103
HSBC (Hong Kong Shanghai Banking Corporation)	DR95*
Incat Australia Pty Ltd	DR56
Insurance Council of Australia	3
Investec Bank PLC	DR72
Joan B Peters	DR44
Jubilee Australia	12, DR71
Kempe Engineering	DR83
King and Wood Mallesons	DR84
Knog Pty Ltd	DR49
Latham & Watkins	DR51
Lean Field Developments	DR78
Leighton Holdings	DR79
Macmahon Holdings	DR47
Macquarie Capital Group	DR45
Marand Precision	DR63
Marine Western Australia Inc	24
McDonnell Dowell Corporation Limited	DR29
Mindful Media	DR94
Mono Pumps (Australia)	DR54
National Australia Bank	DR92
Noja Power	DR32
NSW Business Chamber	DR105
NSW Trade and Investment	25
Oil Search Limited	DR53
Orpheus Geoscience Pty Ltd	DR62
Outotec Pty Ltd – Jagger, Neil	DR68*
Outotec Pty Ltd – Sneyd, Stuart	DR67*

(Continued next page)

Table A.1 (continued)

Individual or organisation	*Submission number*
Outotec Pty Ltd –Whatson, Brad	DR66*
Oxfam Australia	15, DR96
Quickstep	DR41
Riverstone Advisory Pty Ltd	DR88
Santos Ltd	DR64
Screen Australia	17, DR46
Screen NSW	DR91
Screen Producers Association of Australia	DR55
Screenwest	DR76
Société Generale	DR87
Stephens, Malcolm	DR93
Sumitomo Mitsui Banking Corporation	DR99*
Synertec	DR43
Thiess Pty Ltd	DR50
TTG Transportation Technology Pty Limited	1
UGL	DR112
Viocorp International	DR48
Wagner Group Holdings Pty Ltd	DR31
Wellard Rural Exports Pty Ltd	DR34
Westpac	DR97
Whittle Consulting Pty Ltd	DR60
Wiggins Island Coal Export Terminal Pty Ltd	DR37
WorleyParsons	DR39
Zurich Australian Insurance Limited	DR58

[a] An asterisk (*) indicates that the submission contains confidential material NOT available to the public. A hash (#) indicates that the submission includes attachments.

Table A.2 **Visits**

Individual or organisation
ACT
Ausaid
Australian Chamber of Commerce and Industry
Australian National Audit Office
Australian Office of Financial Management
Department of Finance and Deregulation
Department of Foreign Affairs and Trade
Department of Industry, Innovation, Science, Research and Tertiary Education
Department of the Prime Minister and Cabinet
Treasury, The
New South Wales
ANZ
Atradius
Australian Trade Commission
Australian Bankers' Association Inc
Commonwealth Bank of Australia
Ernst & Young
Export Finance and Insurance Corporation
HSBC (Hong Kong Shanghai Banking Corporation)
Insurance Council of Australia
Mohl, Andrew (Chairman - Export Finance and Insurance Corporation Board)
National Australia Bank
QBE Australia
Rabobank
Westpac
Victoria
ANZ
Australian Council of Trade Unions
Business Council of Australia
General Electric
Parkthorn Leisure

Table A.3 **Public hearings**

Individual or organisation	*Transcript page numbers*
Perth — 23 March 2012	
Orpheus Geoscience Pty Ltd	3–13
Marine Western Australia Inc	14–22
Austal Ltd	23–50
Wellard Rural Exports Pty Ltd	51–60
Joan B Peters	61–66
Screenwest	
Hanseatic Marine	
Thornycroft Maritime and Associates Pty Ltd	74–85
Sydney — 26 March 2012	
Aircraft Support Industries	89–96
Jubilee Australia	97–105
Export Finance and Insurance Corporation	106–167
Australian Institute of Export	168–176
NSW Department of Trade and Investment, Regional, Infrastructure and Services	177–190
Stolway Holdings Pty Ltd	191–197
Bronx International Pty Ltd	198–208
Canberra — 27 March 2012	
Australian Services Roundtable	212–221
Australian Chamber of Commerce and Industry	222–234
Sydney — 4 April 2012	
Export Finance and Insurance Corporation	237–303

B Estimating export credit subsidies

Chapter 6 discussed how the use of officially supported export credits could result in the provision of subsidised finance to exporters or buyers of the exported goods. This appendix describes methods researchers have used to estimate export credit subsidies.

B.1 Net present value methods

Boyd (1982) and the OECD (2000) use a net present value method to estimate a subsidy rate. The subsidy rate is the subsidy amount expressed as a percentage of the value of the exports financed by an export credit agency (ECA). For a loan, the calculation requires estimating a 'market' rate of interest that would have been applied without intervention by the ECA and a lower, subsidised rate of interest provided by the ECA. The net present value calculation represents the value of the export credit, taking into account the lower rate provided by the ECA and converting it into a present value by discounting it by the market rate.

Estimating the 'market' interest rate using the cost of capital rate as a proxy

Boyd (1982) estimated the subsidy rate on products offered by Eximbank — the ECA in the United States. Boyd estimated that the subsidy rate for that ECA was at least 2 to 20 per cent for loans issued by the ECA in the period 1976 to 1980.

Boyd estimated the present value of the direct benefit and cost of a loan. Using the terminology of Boyd (1982), the direct cost of a loan in year t is C_t. The direct cost is the amount of the loan.

The direct benefit of the loan is the future stream of payments the ECA will receive on this investment. The benefit stream is $B_t = b_{t+1}, b_{t+2}, \ldots, b_{t+n}$ where b represents payments on the principal and interest on the loan and n is the maturity date (in years).

The present value of direct benefits is:

$$\Gamma_t = \sum_{i=1}^{n} [b_i/(1+m_t^*)^i]$$

Where m_t^* is the market discount rate, defined by Boyd (1982) as the risk-adjusted private market discount rate.

Boyd (1982) assumes that loans are repaid semi-annually, with ψ denoting the delay in payments to the ECA as a proportion of the average maturity of loans and m_t the average rate of interest on new loans. Under this method, the present value of direct benefits provided by the ECA can be written as:

$$\Gamma_t = \left({C_t}/{m_t^*} \right) \Big\{ m_t(1 - [1 + (m_t^*/2)]^{-2n}) + [n(1-\psi)]^{-1} \\ \times \{[1 + (m_t^*/2)]^{-2n\psi - 1} - [1 + (m_t^*/2)]^{-2n}\} \Big\}$$

A key parameter to estimate using Boyd's method is the market discount rate, m_t^*. Boyd (1982) states the market discount rate is the cost of capital rate that Eximbank would have faced had it been a private firm. It would have paid taxes, been required to earn a market-determined rate of return on its equity, and possibly borrow in corporate debt markets.

If the market value of a firm is denoted by V, and the firm is financed partly with debt (L) and partly with equity (E), such that $V = L + E$, the firm will acquire assets up to the point where:

$$m^* = [r_e(1-K)/(1-\tau)] + r_l K$$

Where r_e is the cost of equity capital, $K = L/V$, τ is the corporate tax rate, and r_l is the cost of debt to the firm.

Accordingly, determining the risk-adjusted private market discount rate requires estimation of the four elements of the above equation. The cost of borrowing, r_l, can be estimated using data on corporate bond yields, and τ can be determined from company tax rates.

Estimation of r_e and K requires a comparator group of firms that undertake similar activities to the ECA. Boyd (1982) used a sample of banks in the United States.

Boyd (1982) outlines two methods to estimate the cost of equity, r_e. One involves using the Capital Asset Pricing Model (CAPM), which requires a risk-free rate of interest, expected rate of return on a market portfolio, and company betas, where beta measures the extent to which a company's stock returns move with those of the rest of the market.

The second approach is to capitalise a stream of expected future dividends. If D denotes current dividends per share, P denotes the current share price, and $E(g)$ is the future expected growth rate in dividends per share, the cost of equity capital can be written as:

$$r_e = (D/P) + E(g)$$

$E(g)$ is an expectation variable and a proxy of it is the geometric growth rate in dividends per share between the current year and four years prior.

It is also necessary to estimate $K = L/(E + L)$, and therefore, what the values of the ECA's debt and equity would have been if it were a private corporation. The calculation for the market value of equity is based on the following formula:

$$E = \pi(1 - \tau)/r_e$$

Where π is the profit reported by the ECA in a given year.

To estimate the market value of debt that the ECA would have carried had it been a commercial entity, the following equation is used:

$$L = I/r_l$$

Where I is the interest expense reported in a particular year.

The cost of borrowing, r_l, is estimated by corporate bond rates.

Once these variables are estimated, m_t^* can be determined and the subsidy can be estimated.

The method that Boyd (1982) used requires estimation of many variables — in particular, the cost of equity requires either estimating a CAPM model or dividend growth model. Both of these models have many assumptions underlying them.

Boyd's method only generates one market discount rate, in each year, applied across all loans. This method is not useful when examining the subsidy for different loans, with different risk levels. Chapter 6 showed that the risk of a facility such as a loan (measured by the EFIC risk score) can vary, and that facilities with higher risk should have a higher interest rate margin. Under Boyd's approach, there is only one market discount rate used to discount all loans. This can over or underestimate the subsidy rate. In cases where two loans are priced with different interest rates, reflecting their different risk levels, the one with the higher interest rate margin would have a larger estimated subsidy rate and be biased upwards compared to the loan with lower risk (and lower interest rate margin). Thus Boyd's method will not provide an accurate subsidy rate for the purposes of comparing the subsidy across different transactions.

Mapping of credit ratings to 'market' interest rates

The OECD (2000) examined the subsidy of some OECD countries. Thirteen countries were included in the analysis, although the study was restricted to agricultural exports. To generate the market rate of return (market interest rate), the study considered what the borrower in the country that received the exports would have paid (not what similar private sector providers would offer, as in the case of Boyd (1982)). This was done by evaluating the credit risk of the country that imported the agricultural export and assigning it a corresponding 'market' interest rate. A different market rate was obtained for different loans, depending on the country of export destination and its associated credit risk.

Similar to the approach of Boyd (1982), the OECD (2000) also used a net present value formula to estimate the subsidy rate.

Under the 'Ohlin formula' that was used the subsidy rate, S, is defined as:

$$S = \left(1 - \frac{g}{r}\right)\left[1 - \frac{\frac{1}{(1+r/a)^{aG}} - \frac{1}{(1+r/a)^{aT}}}{r(T-G)}\right] - f$$

Where g is the interest rate that the ECA charges, r is the market interest rate, a is the number of repayments made per year, T is the term of the loan in years and G is the grace period in years. f is the initial fee paid from the borrower to the ECA expressed as a percentage of the value of the loan.

This formula, and other net present value formulas, can generate imprecise estimates of subsidy rates in some cases. For example, Yassin (1989) notes that if the market interest rate in the Ohlin formula is equivalent to the interest rate of the ECA ($g = r$) then the subsidy rate (excluding the initial fee) is zero, irrespective of the loan's grace period or maturity. To obtain more accurate subsidy rate estimates in these cases Yassin (1989) provides a different method to estimate the subsidy rate. Unlike the Ohlin formula, Yassin's method can more accurately estimate the subsidy rate for bullet loans (that is, where the grace period is the same as the term of the loan, or $T = G$) and generates non-zero subsidy rate estimates when the subsidised rate (g) and market rate (r) are the same, but other terms differ.

To estimate the market interest rate using the Ohlin formula, the OECD (2000) drew on an earlier paper that mapped credit ratings to interest rates. To convert a credit rating to an interest rate, the first step was to convert credit ratings (from Moody's and Standard & Poor's) into ordinal rankings. For example, AAA = 1, AA+ = 2, A2 = 6. A regression is then specified to derive a relationship between credit ratings and contemporaneous interest rates. It also controls for tenor, currency and other factors.

Under this method interest rates vary according to risk, meaning a more accurate relationship between price and risk is estimated, compared to having one interest rate across all risk classes (as is the case with Boyd's cost of capital calculation).

Although there are some data limitations with this analysis (for example, missing data for some observations) the authors maintain confidence in the method to map interest rates and credit ratings. (The r-squared for the regression is 82 per cent). An important caveat, however, is that the method assumes that credit rating agencies' valuations of sovereign credit risk is accurate:

> The interest rate estimates are intended to be as accurate as possible and as complete as required for the purposes of the present study. However, there are legitimate arguments that the interest rates allow an additional element of error beyond the survey data … First, they are derived from an estimated contemporaneous relationship between credit ratings and interest rates. The original credit ratings may contain errors and the estimated link also has statistical errors although, as already discussed, the original study reports good statistics of fit. (OECD 2000, p. 48)

The study found the overall subsidy rate across the thirteen countries to be less than four per cent. The United States had the highest subsidy rate (6.6 per cent), and contributed to the majority of distortion in agricultural exports. Other countries, including Australia, had lower estimated subsidy rates.

The authors undertook sensitivity analysis to examine how the subsidy rate would change if the estimated market interest rate was different. An increase in the market interest rate of one per cent led to an increase in the overall subsidy rate from 2.6 to 3.5 per cent. The small change reflects that the analysis was restricted to agricultural sector export credits, which have a short tenor compared to exports from other industries. The majority (55 per cent) of export credits used in the analysis had a tenor of less than one year. The estimated subsidy rate increases as the tenor of an export credit increases, all else equal.

B.2 Other methods

Pricing that reflects full economic costs of provision

NERA (2003) reviewed the UK's Export Credits Guarantee Department (ECGD) and found it provided a subsidy because its pricing model did not allow for a cost of capital:

> … ECGD is currently not required to provide a return on the notional capital required to run its business. This means that premiums charged by ECGD do not reflect the cost of the notional capital required to meet claims arising from ECGD's portfolio of exposures and, thereby, comprise a subsidy element. (NERA 2003, p. ii)

Therefore, to estimate the subsidy, NERA required an estimate of the cost of capital amount and cost of capital rate. NERA considered two approaches to determine the cost of capital rate, by comparing the rate of return from:

- private sector providers that provide similar products to those of ECGD
- other government organisations — because ECGD is government-owned and should earn a rate of return that the UK Government requires for public-owned entities.

The UK Government requires that the rate of return on capital for public-owned entities be no less than 8 per cent (NERA 2003). Alternatively, the cost of capital rate is estimated by NERA to be 11 per cent pre-tax real if it was assumed that ECGD operates as a private sector provider. To estimate the private sector cost of capital rate, a CAPM equation was used to estimate the return on equity for insurance companies in the United Kingdom. This approach is one of the two methods Boyd (1982) used to estimate the cost of equity.

With a cost of capital rate determined, the authors then require an estimate of the capital amount required for unexpected losses. A value-at-risk portfolio pricing approach is used. This approach assumes there is some covariance between the return of one transaction and the rest of the portfolio. The higher the covariance (less diversified the risk of the portfolio) the greater the required capital amount.

With a cost of capital estimated, NERA requires the expected loss and administration charge to determine an 'ideal price' that ECGD should charge. The difference between the 'ideal price' and the price ECGD charges is the estimated subsidy.

To estimate expected losses, NERA used ECGD's own pricing model:

> Regarding expected losses (i.e. the mean loss), these were taken from ECGD's in-house credit models. Utilising all of the parameter values as set out, we calculated an 'ideal price' for each exposure and compared this to the price actually charged by ECGD. (NERA 2003, p. iv)

This method requires estimating a cost of capital rate (if it is assumed that an ECA should earn a return comparable to private sector providers). As noted above, this could be done using a CAPM model, which requires various assumptions. The method also requires that inputs in the pricing model (including default probabilities) are accurate, in order to correctly estimate the 'ideal' price.

Option pricing of export credit guarantees

Dahl et al. (1995) evaluated the price of export credit guarantees using an option pricing model. The study was applied to US agricultural commodities and compared the export credit program features for credit guarantees of the United States to those of other, competing countries, including Canada, France and Australia.

The authors used the Black-Scholes option pricing model to estimate the value of a credit guarantee. That model provides an estimate of a 'fair market value' of the guarantee if it were traded on an organised exchange, and is comparable to the 'actuarially fair' premium an insurer (importer or US bank) would pay for the guarantee.

The Black-Scholes option model assumes that the value of the credit guarantee is a function of the term of the loan guarantee, the guarantee price, and current value of the asset. The model can also be extended to allow for coverage of freight and insurance and exchange rate guarantees.

The paper did not aim to estimate a subsidy, but it could be inferred from the results. The authors concluded that the overall subsidy was about 13 per cent (aggregated across all countries), but noted the estimate is sensitive to critical variables that were unobtainable. For example, the default risk of the importer is represented by the volatility or price level of the underlying asset, which is the letter of credit. The authors found that 'changes in either the volatility or price level of the letter of credit, within the range examined, has a dramatic impact on the value of credit guarantees' (Dahl et al. 1995, p. 12), highlighting the importance of correctly estimating default probabilities in order to price export credit guarantees accurately.

C Approaches of other ECAs: similarities and differences

The export credit agencies (ECAs) of most countries share similar features in their design and operations. This is in part due to the *OECD Arrangement on Officially Supported Export Credits* (OECD 2011a) which was prepared to harmonise the terms on which official export credits are provided. However, there are a number of important distinctions between them that can provide lessons about the scope and effectiveness of ECAs. This appendix provides background about other ECAs, and explores some of these differences.

C.1 Institutional models

ECAs broadly fall into three institutional models:

- departmental
- state-owned corporation or agency
- private company as agent (Wang et al. 2005).

Departmental model

Although ECAs are typically subject to ministerial or departmental oversight, setting up an ECA as a government department is relatively uncommon. The UK's Export Credits Guarantee Department (ECGD) is one example of this arrangement.

The various institutional models represent a range of tradeoffs between independence — that is, freedom for the entity to make its own commercial decisions — and accountability. Good governance arrangements could ensure these under any of the models. However, ECAs set up under a departmental model are typically less structurally independent than those constituted under an arm's length state-owned corporation or agency model (although they may have greater financial and governance accountability).

State-owned corporation or agency model

The state-owned corporation or agency model provides greater autonomy and makes ECAs less amenable to political intervention than the departmental model. It is the most commonly employed model for ECAs around the world, with examples including agencies such as Australia's Export Finance and Insurance Corporation (EFIC), the Export-Import Bank of the United States (Ex-Im Bank) and the New Zealand Export Credit Office (NZECO).

There are varying arrangements between ECAs constituted under this model, incorporating differing degrees of independence. For example, the Ex-Im Bank in the United States is constituted as an independent agency by Congress. In contrast, NZECO is set up as a business unit within the NZ Treasury, with the Secretary of Treasury approving all transactions after advice from technical advisers and an independent agent. This level of oversight could help to ensure funds are wisely and appropriately spent. However, there is still a potential for reduced independence. The senior departmental official who reports to the NZ Minister must take into account the views and instructions of the Minister, when deciding on individual transactions. That said, legislative measures to prevent ministers intervening in individual transactions could go some way to dealing with this potential problem — such arrangements are common in other areas of Australian Government public administration, where senior department officials have some statutory decision-making powers.

Where the objectives of an ECA are largely commercial, the state-owned agency model allows ECAs to pursue those objectives relatively free of political constraints. However, the effectiveness of the model is dependent on the adequacy of governance arrangements.

Private company as agent model

In some countries, governments have entered into arrangements with private companies to fulfil the ECA role. Examples of such arrangements include Coface in France, Euler Hermes in Germany and Atradius in the Netherlands. Under these arrangements, the companies perform the initial risk analysis and transact on the government account. Where the private company is acting as an agent for the government, all risks typically remain with the government (Wang et al. 2005).

There are potential efficiency gains from private-sector involvement under this model, particularly if there is contestability for the ECA role. There are also potential benefits flowing from the relative independence of the agency under this model. However, these benefits are not guaranteed and depend heavily on governance arrangements. There is also potential for higher transaction costs and conflicts of interest between the government and the private company involved. Under the model, governments can still provide direction on the ECA's overall direction and priorities.

In 2011, the Norwegian Government announced that it would transfer administration of its export credit scheme from the private company Eksportfinans to a newly formed government agency. The decision follows the imposition of more stringent European Union rules on large exposures which Eksportfinans was not able to satisfy. Eksportfinans will manage the Norwegian scheme until the establishment of the new agency by 1 July 2012. As it is not able to satisfy prudential requirements, Eksportfinans is not able to issue new loans in its own name but will manage the runoff of its existing portfolio (Norwegian Ministry of Trade and Industry 2011).

C.2 Portfolio responsibility

The portfolio responsibility for an ECA varies across countries and can potentially have an impact on its priorities. In Australia, EFIC is part of the Foreign Affairs and Trade portfolio and is the responsibility of the Minister for Trade and Competitiveness. NZECO has similar objectives, although it operates as a business unit within the NZ Treasury, and is overseen by the Minister of Finance (although the Ministers of Trade, and of Economic Development, are also provided with NZECO's strategic plan for approval).

Other countries have different approaches. Japan's Nippon Export and Investment Insurance (NEXI) is the responsibility of the Minister of Economy, Trade and Industry. The Ex-Im Bank in the United States is an independent government corporation established by the Congress, with the board appointed by the President after congressional advice and consent.

C.3 Product offerings

Product offerings represent a key difference between ECAs; in particular whether an ECA offers direct finance. ECAs that offer direct finance, in addition to insurance and guarantees, include EFIC, Japan's Bank for International Cooperation (JBIC) and Export Development Canada (EDC). ECAs that are restricted to insurance and guarantee-type products include the NZECO and NEXI.

Where ECAs can offer a range of products, there are advantages of greater flexibility for the ECA. However, against this there are also the larger potential costs associated with the distortions to financial and other markets, and the greater potential for crowding out private sector financiers. Greater flexibility also provides greater scope for organisations to go beyond their mandate.

There has generally been a move away from ECAs providing short-term products due to the increased capacity and preparedness of private sector markets to undertake this role. Australia, the United Kingdom and Denmark have privatised the short-term operations of their ECAs (IFC 2006), although the UK ECA has recently re-entered the market for some short-term products in response to perceived problems in obtaining credit following the global financial crisis (Crawford 2011). Several ECAs continue to provide short-term finance products. For example, EDC is still Canada's dominant provider of short-term insurance for exporters (DFAT, sub. 19).

A further key influence on the product offerings of ECAs is the other government organisations operating in the same or similar policy space in a particular country. Where a country has development finance institutions (such as the Overseas Private Investment Corporation in the United States) or institutions designed to help small and medium-sized enterprises (SMEs) (such as the Business Development Bank of Canada), the ECA's product range is likely to be narrower, in part to prevent overlap between organisations.

Some countries have more than one ECA, with each organisation performing different roles. For example, Japan has two ECAs, the JBIC providing direct financing, and NEXI providing insurance. China and India have similar arrangements to Japan.

C.4 Eligibility for assistance

The *Export Finance and Insurance Corporation Act 1991* (Cwlth) contains a number of provisions limiting the products that EFIC is able to offer, and the circumstances under which they are able to offer them. EFIC also has internal policies designed to ensure compliance with the Act in areas such as local content.

For example, EFIC noted:

> Currently, EFIC generally requires an Australian content level for its export finance products of 50 per cent, reflecting the use of the language 'produced or manufactured wholly or substantially in Australia' in the definition of 'eligible export transaction' (in section 3(3)) and similar language is used in the definition of 'export contract' (in

section 3(1)). Both definitions form the basis of the eligibility criteria for certain [types] of EFIC's Part 4 products and services (sub. 18, appendix A, p. 36).[1]

EFIC has noted in its initial submission that ECAs are typically moving away from 'local content' rules regarding which exports it can support. EFIC sees these as 'dated given the increased use of imports in production as a strategy by Australian firms to provide cost competitive products through global supply chains' (EFIC, sub. 18, appendix A, p. 36).

A number of ECAs (such as Austria's OeKB, Belgium's ONDD, Canada's EDC, China's Sinosure, Denmark's EKF, Finland's Finnvera, Italy's SACE, and most recently NZECO)[2] have introduced eligibility criteria based on a benefits test (EFIC, sub. 18). EFIC considers a 'national benefits' test 'would allow a wider range of factors (such as dividend flows and improved access to markets) to be taken into account, in determining whether EFIC's support may be appropriate for a particular proposal (EFIC, sub. 18, appendix A, p. 36). The merits of such a change are discussed in chapter 10.

Eligibility for EFIC's assistance, as with most ECAs, is primarily focused on domestic companies that are exporting or investing overseas. However, the relationship between an ECA's clients and exporters may not always be direct. Some governments have relaxed the eligibility for ECA support to include domestic activity in specific circumstances. In 2008, the Government of Canada extended the powers of EDC to support domestic lending for a period of two years in response to the global financial crisis (Argitis 2010). This has been extended until 2013 (EDC 2012b). The US Government announced in February 2012 that eligibility for Ex-Im Bank financing would be extended to US firms competing with foreign companies for domestic sales. This is intended to assist US firms by 'matching financing support to counter foreign non-competitive official financing that fails to observe international disciplines' (White House 2012).

C.5 Focus on small and medium-sized enterprises

In the draft report, the Commission recommended that until it is next reviewed, EFIC's role on the commercial account should be limited to demonstrating to the

[1] The EFIC website notes that some assistance can be provided for Australian content under 50 per cent in particular circumstances (EFIC, ndc).

[2] Oesterreichische Kontrollbank AG (OeKB); Office National du Ducroire (ONDD); China Export and Credit Insurance Corporation (Sinosure); Eksport Kredit Fonden (EKF); Finnvera Oyg (Finnvera); SACE S.p.a. Servizi Assicurativi del Commercio Estero (SACE).

private sector that providing export finance to newly exporting SMEs can be commercially viable.

The Commission is not aware of any ECA that explicitly limits its activities to SMEs, but some ECAs are expected to have an SME focus. For example, Ex-Im Bank has been mandated by Congress to have a particular focus on SMEs. This includes a requirement that it set aside 20 per cent of its authorised funding specifically to support exports by small businesses. About 85 per cent of Ex-Im Bank's transactions benefit small business directly (which is approximately 18 per cent of the bank's business by value in 2011) (Ex-Im Bank 2012).

ECAs also commonly report on their dealings with SMEs. EDC has highlighted that about 80 per cent of the companies it supported in 2010 were SMEs (which represented about 10 per cent of business facilitated by EDC by value) (EDC 2011). The ECGD has recently re-badged itself as 'UK Export Finance' for trading purposes to generate more awareness of its operations among potential SME clients (Crawford 2011). Although governments often encourage their ECAs to promote their services to SMEs, the majority of their business by value is consistently with larger firms.

In its submission to the draft report, EFIC stated that its support for SMEs was relatively greater than either Ex-Im Bank or EDC. It cited that 89 per cent of its signings by number and 23 per cent by value were with SMEs in 2010-11 (EFIC, sub. DR90). EFIC stated:

> The conclusion therefore that EFIC is 'focused on large corporate clients' as evidenced by EFIC's supposedly 'low' level of support for SMEs and the following Draft Recommendation that EFIC should limit its services to 'newly exporting' SMEs only is incongruous with the reality of EFIC's activities and those of its international counterparts. (sub. DR 90, p. 75)

However, EFIC has a higher cut-off for its definition of SMEs (turnover of A$150 million) than either Ex-Im Bank or EDC, and other Australian Government agencies and private sector providers (chapter 2). This allows EFIC to classify larger businesses as SMEs. By comparison, EDC defines an SME as any business with total annual turnover of less than Can$25 million (EDC 2008). Ex-Im Bank's definition of small business is determined by the U.S. Small Business Administration, which classifies businesses based on turnover or employee numbers depending upon the industry. Industries such as services, retailing and construction are classified as small businesses if they have annual turnover of less than about US$20 million. The ceiling for manufacturing and wholesaling businesses ranges from 100 to 1500 employees depending on the type of product manufactured or provided (US Small Business Administration 2012).

Furthermore, the Commission's recommendation of a mandate for EFIC that is focused on SMEs was not made on the basis that it corresponds to the mandates of other ECAs. Instead, it was made on the basis of evidence related to Australia's ECA and a market failure rationale for EFIC's operations on the commercial account.

C.6 Competition with the private sector

Although there are usually ongoing concerns about crowding out, it is generally intended by governments that ECAs (including EFIC) do not compete with the private sector. However, some ECAs have broad mandates and are more likely to be competing with the private sector than others. For example, a 2008 review of EDC found 'there can be no doubt that EDC operates outside any 'market gap', however defined' (International Financial Consulting 2008, p. viii).

In recent years, the private sector has improved its capacity to meet the needs of exporters in most countries. The role of ECAs has generally been wound back, although since the emergence of the global financial crisis this trend has been reversed in some countries, at least temporarily.

The winding back has also been influenced by:

- pressure on government budgets (which has reduced funding for ECAs in some countries)
- the OECD Arrangement that was established in 1978 and has increased in scope since then (reigning in ECA activity in some countries)
- the European Commission guidelines set in 1997 to dissuade the governments from competing with the private sector (Wang et al. 2005).

ECAs can often enter into risk-sharing arrangements with the private sector on the basis that this will facilitate private sector participation in the export credit sector. For example, Wang et al. (2005) observed that many ECAs become more willing to enter into risk-sharing arrangements with the private sector as the role of the private sector increases. The logic behind these arrangements has generally been that ECAs take on political risks, while the private sector takes on commercial risk. For example, ECAs have acted increasingly as reinsurers. The ECAs in the United Kingdom and Denmark maintained backstop reinsurance facilities after their withdrawal from short-term business.

The Commission has also noted that ECAs enter into risk-sharing arrangements with each other.

C.7 Commercial focus

The degree to which ECAs are required by their governments to have a commercial focus varies. Most ECAs are obliged by their governments (and international agreements) to recover the cost of their operations from their fees and charges without drawing on government funding. Most ECAs have provisions in their legislation or administrative rules that permit the payment of dividends or surplus funds to their shareholding governments. EFIC, Ex-Im Bank, EDC, JBIC and ECGD have paid dividends or excess funds to their governments in recent years.

ECAs also typically claim that they price their products to recover their costs and do not provide subsidies. The provision of export credits by ECAs is governed by various international agreements intended to promote the sustainability of ECAs, reduce competition based on subsidised financing and provide a mechanism through which to resolve disputes when they arise. These agreements include the OECD Arrangement on Officially Supported Export Credits, and World Trade Organisation (WTO) Agreements on Subsidies and Countervailing Measures (ASCM) and Agriculture.

However, the existence of these agreements does not guarantee subsidies do not occur. The OECD Arrangement is a gentlemen's agreement, applies only to a relatively small number of OECD countries and is not enforceable. Almost all countries are a party to the WTO ASCM but taking action is a long and involved process.

ECA activity has resulted in a number of claims of trade distorting subsidies. Since 1995 the WTO dispute settlement body has examined six cases brought by member governments alleging the provision of subsidised export credits. These include:

- a 2001 complaint from Brazil that EDC provided subsidised buyer finance for aircraft exported from Canada — the WTO panel ruled that EDC charged interest at rates below those available commercially and this constituted a subsidy
- a 2003 complaint from the European Communities that the Korean Export-Import Bank (KEXIM) provided subsidised pre-shipment loans and advanced payment refund guarantees to Korean shipyards — the WTO ruled that KEXIM's fees and interest rates were below what could be obtained on the market and were, therefore, a subsidy (WTO 2010).

Although WTO dispute resolution panels have interpreted the language of the ASCM to mean that an export credit that is priced below the market price is a subsidy (Coppens 2009), many ECAs have interpreted the ASCM to mean they only need to price their products such that they recover their costs. This latter benchmark is a low hurdle and does not ensure that subsidies do not occur if ECAs that are guaranteed by their governments do not account for lower borrowing costs in their pricing techniques. Negotiations on WTO rules are ongoing and the definition of an export credit subsidy is a particularly contentious issue (box C.1).

ECAs have also been accused of providing subsidies by some companies competing with the beneficiaries of ECA financing. In an address to the US Chamber of Commerce, the CEO of Delta Airlines Richard Anderson stated that the company opposes Ex-Im Bank loan guarantees to foreign airlines purchasing Boeing aircraft because it assists its overseas competitors. He stated:

> [Delta] spent [US]$300 million to buy two widebody airplanes to serve India, and a government-sponsored carrier comes in with Ex-Im Bank [support] and basically takes you out of the market because they're pricing [US]$300 or [US]$400 a ticket below you. (Carey 2012).

In 2011 the Air Transport Association of America sued Ex-Im Bank to stop it providing US$3.4 billion of loans to Air India for it to purchase Boeing aircraft. The ATA alleges the finance is subsidised and will harm competing US airlines (Air Transport Association of America 2011).

ECAs and governments have also identified subsidised export credits as an issue. In its submission to the Australia in the Asian Century White Paper, EFIC identified ECA activity in Australia as potentially subsidised:

> Such activities are feeding concerns that non-OECD ECA offshore investment financing, both tied and untied to exports, may be distorting international purchasing and investment decisions as firms from those countries are receiving subsidised financing … (EFIC 2012e, p. 11)

The White House, in a press statement announcing new powers for Ex-Im Bank stated:

> The President will not allow U.S. companies and workers to lose out on valuable business due to unfair export financing — and will use the Administration's full powers to ensure they are competing on an even footing. (White House 2012)

Box C.1 **Export credit subsidy benchmarks**

The WTO Agreement on Subsidies and Countervailing Measures (ASCM) uses language that suggests prohibited export credit and guarantee subsidies are defined according to a 'cost-to-government' benchmark. Under this definition, an ECA's export credits are deemed not to be prohibited export subsidies if they are priced above the ECAs costs.

This is a low hurdle because ECAs have better credit ratings and may be able to provide export credits at a lower cost than private sector providers (not including the implicit cost of ECA government guarantees). In doing so they could provide a subsidy without contravening the ASCM.

In the most recent round of ASCM negotiations, some WTO members asserted that the cost-to-government definition places developing countries at a disadvantage. This is because developing countries generally have a higher cost of funds than developed countries and cannot match the terms offered by developed countries.

Some WTO members have argued that the cost to government benchmark for defining prohibited export subsidies should be replaced with a 'benefit-to-recipient' benchmark. This would oblige ECAs to charge market prices for their products and reduce the likelihood of subsidies occurring.

However, this has been opposed by some WTO members who argue that the current language is consistent with the OECD Arrangement of Officially Supported Export Credits and changing the benchmark would increase the cost of trade finance. They also argue that since most developing countries are importers of capital goods, low cost of trade finance actually benefits them.

Source: WTO (2011).

C.8 Exposure concentration

Many ECAs have high exposures to particular counterparties or industries/sectors, reflecting economic and political demand for their products. Sectors to which ECAs commonly have high industry exposures include transportation, shipping and aerospace. EFIC has a high concentration of exposures to ship-related industries (chapter 8). High exposure concentration to counterparties or sectors can result in large losses if adverse circumstances affect the counterparty or sector.

ECAs benefit from the financial backing of their countries' governments and may be exempt from prudential requirements limiting large exposures (chapter 8). Table C.1 presents the largest industry exposures of several ECAs and private providers. For ECAs for which data are available, the largest industry exposure generally exceeded those of private providers operating in similar markets in 2010-11 (table C.1).

Table C.1 **Largest classified industry/sector exposure for selected ECAs and private providers, 2010-11[a]**

	Industry/sector	*Exposure*
		% of total
ECAs		
EFIC (Australia) (2011)	Ship building and operations	30.8
Ex-Im Bank (US) (2011)	Air transportation	48.2
ECGD (UK) (2011)	Civil aerospace	62.4
Hermes Cover (Germany) (2010)	Ships	18.7
EDC (Canada) (2011)	Transportation	27.0
KEXIM (Korea) (2011)		
Loans	Manufacturing	45.4
Guarantees	Manufacturing	70.7
SACE (Italy) (2010)	Oil and gas	22.0
Private providers		
Atradius (2011)	Consumer durables	12.1
Coface (2010)	None greater than	10.0
Euler Hermes (2011)	Construction	14.5

a Industries/sectors are presented as defined by the relevant organisation in its 2010 or 2011 Annual Report.

Source: Atradius (2012); Coface (2011); ECGD (2011); EDC (2012a); EFIC (pers. comm., 25 November 2011); Euler Hermes (2012); Ex-Im Bank 2011a; Hermes Cover (2010); KEXIM (2012); SACE (2010).

D Other government bodies

As discussed in chapter 9, a range of governance frameworks and financial management arrangements apply to Australian Government statutory bodies (both authorities and companies) subject to the *Commonwealth Authorities and Companies Act 1997* (Cwlth) (CAC Act). This appendix compares EFIC's governance and reporting arrangements with those of four CAC Act bodies: Airservices Australia, Australia Post, Medibank Private and the Australian Reinsurance Pool Corporation (ARPC). There are various governance models adopted by CAC Act bodies to undertake their activities and meet objectives. Governance frameworks vary in terms of:

- the scope of ministerial powers to direct authorities or companies in performing their functions
- board composition and committees
- reporting and disclosure requirements relating to planning and performance
- regulation and reporting of pricing of services.

Some characteristics of EFIC and other CAC Act bodies are summarised in table D.1, as well as requirements relating to competitive neutrality and payments to government.

Table D.1 **Governance and other characteristics of selected CAC Act bodies**

	Airservices Australia	*Australian Postal Corporation*	*Medibank Private Limited*	*Australian Reinsurance Pool Corporation*	*Export Finance and Insurance Corporation*
Type of CAC Act body[a]	Authority, PNFC	Authority, PNFC, GBE	Company, PFC, GBE	Authority, PFC	Authority, PFC
Enabling or applicable legislation	*Airservices Act 1995,* (AA Act), *Air Navigation Act 1920, Aviation Transport Security Act 2004, Civil Aviation Act 1988*	*Australian Postal Corporation Act 1989* (APC Act)	*Private Health Insurance Act 2007* (PHI Act)	*The Terrorism Insurance Act 2003* (TI Act)	*Export Finance and Insurance Corporation Act 1991* (EFIC Act)
Principal activities	Air traffic control and related services, aviation rescue and fire fighting	Supply of postal services within and outside Australia	Operation of private health insurance business in accordance with the PHI Act and Regulations, and direct or indirect provision of a range of insurance services	Provides reinsurance cover to primary insurers for losses to commercial property and associated business interruption arising from a declared terrorism incident	Provision of export credits, insurance, reinsurance and other financial services that support Australian exports and overseas investments
Ministerial power to give directions[b]	✓ AA Act, s. 16	✓ Except in relation to rates of postage (APC Act, s. 49)		✓ APC Act, s. 38	✓ EFIC Act, s. 9
Composition of Board/Executive	Chairperson, deputy chair, non-executive directors appointed by the Minister. CEO appointed by the Board	Chairman, deputy chairman, non-executive directors appointed by the Governor General on the nomination of the Board	Executive managing director, non-executive chairman and directors appointed by the Minister. A company	Chairperson and non-executive members of the Board appointed by the Minister. The CEO is appointed by the Board	Managing director and CEO, executive directors, chief financial officer & board secretary, and chief credit officer

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Table D.1 (continued)

	Airservices Australia	*Australian Postal Corporation*	*Medibank Private Limited*	*Australian Reinsurance Pool Corporation*	*Export Finance and Insurance Corporation*
		Minister. Managing Director appointed by the Board	Secretary is appointed by the Board		Managing director is appointed by the Board
Government board member				✓	✓
Board or executive Committees	Audit and Risk, Safety, Environment, Remuneration, Ethics	Audit and Risk, Human Resources, Superannuation	Audit and Risk, Human resources, Investment, Nomination, Health and Business Innovation	Audit and Compliance, Risk	Audit, Credit, Risk and Compliance, Treasury Risk Review
Publishes Corporate Plan	✓				
Treasury functions/investment powers	The AA Act provides for Airservices to enter into approved contracts in relation to foreign currency and interest contracts, futures, commodity contracts	Treasury policy provides for the use of hedging instruments to protect against adverse interest rate and foreign exchange rate movements	Board delegates to an Investment Committee the powers to authorise derivative purchases and/or sales to manage the investment portfolio	Cash deposits are managed internally, the balance of pool funds in medium-term investments are managed by external fund managers. All investments are held in the ARPC's name	Treasury operations borrow on international capital markets, structure cash flow in Australian and foreign currencies and manage EFIC's investment portfolio of capital and reserves
Borrowing powers in its own right	✓ AA Act, s. 11	✓ APC Act, s. 61	✓ MPL Constitution, s. 35.2(a)	✓ Under s. 38 of the TIA Act, Minister may give directions requiring the ARPC to enter in to contracts to borrow	✓ EFIC Act, s. 58-59

(Continued next page)

Table D.1 (continued)

	Airservices Australia	*Australian Postal Corporation*	*Medibank Private Limited*	*Australian Reinsurance Pool Corporation*	*Export Finance and Insurance Corporation*
Price regulatory arrangements	The board's power to set prices for core services is subject to price notification provisions under Part VIIA of the *Competition and Consumer Act 2010.* Minister can make price determinations	Declared letter services are subject to price notification provisions under Part VIIA of the *Competition and Consumer Act 2010.* (although certain letter services are excluded).[c] The ACCC can inquire into disputes about pricing of access to Australia Post's bulk mail services	MPL can vary future premium rates subject to the approval of the Minister for Health and Ageing and the requirements of PHI Act	The Minister gives written directions to set premium rates charged by the ARPC under reinsurance contracts (TI Act, s. 38 (d))	The OECD Arrangement on Officially Supported Export Credits establishes minimum prices and maximum terms for export credit. The WTO Agreement on Subsidies and Countervailing Measures prohibits rates below long-term cost recovery
Subject to competitive neutrality arrangements[d]	✓	✓	✓		
Tax or tax equivalent payments	✓ Airservices Australia is subject to income tax and GST	✓	✓	The ARPC is exempt from income tax under s. 36 of the TI Act. It is subject to FBT and GST	EFIC is exempt from income tax and other taxes under s. 63 of the EFIC Act. EFIC is subject to GST and FBT
Payment of debt neutrality charge	Interest on capital is not payable to the Commonwealth but the capital is repayable to the Commonwealth at such times as determined by the Minister in writing (AA Act, s. 44)	✓ No current borrowings. Borrowing terms must comply with competitive neutrality	✓ No current borrowings. Borrowing terms must comply with competitive neutrality		

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Table D.1 (continued)

	Airservices Australia	*Australian Postal Corporation*	*Medibank Private Limited*	*Australian Reinsurance Pool Corporation*	*Export Finance and Insurance Corporation*
Commonwealth guarantee of liabilities	Airservices has an implicit Commonwealth guarantee by virtue of its government ownership	Australia Post has an implicit Commonwealth guarantee by virtue of its government ownership	MPL has an implicit Commonwealth guarantee by virtue of government ownership	The TI Act provides an explicit Commonwealth guarantee of the ARPC's liabilities (s. 35)	The EFIC Act provides an explicit Commonwealth guarantee of the ARPC's liabilities (s. 62)
Commercial rate of return required under competitive neutrality policy	✓	✓	✓		
Dividend policy	✓ Based on board recommendation to the Minister	✓ Consistent with part 4 GBE governance arrangements	✓ Consistent with part 4 GBE governance arrangements	✓ The TI Act provides that the Minister may direct the ARPC to pay dividends to the Commonwealth. However, no such payments have been made to date	✓ Based on board recommendation to the Minister

[a] Prescribed bodies under the *Commonwealth Authorities and Companies Act 1997* (Cwlth) are Commonwealth authorities (s. 62) or Commonwealth companies (controlled by the Commonwealth) and are classified as either Public Non-Financial Corporations (PNFC) or Public Financial Corporations (PFC). Some government bodies are also government business enterprises (GBEs) under s. 5 of the Act. [b] Refers to ministerial directions in relation to performance of functions or exercise of powers. [c] Letter services excluded under clause 5(2) of the Price Notification Declaration for Australian Post include those not reserved to Australia Post under Part 3 of the APC Act, those that involve supply of a special service for which a special charge or additional fee is applicable and those under an incoming mail service to which a convention applies. [d] In accordance with the Commonwealth Government Competitive Neutrality Statement of June 1996, Airservices Australia, Australia Postal Corporation and Medibank Private Limited are the types of Commonwealth Government businesses to which competitive neutrality arrangements were intended to apply.

Sources: Airservices Australia (2011); ARPC (2011a); Australia Post (2011); Department of the Treasury (2007); EFIC (2011a); HoTs (2009); Medibank Private (2011).

D.1 Governance arrangements

Independence from government

The enabling legislation establishes the relationship between the Minister and each government body, including the extent to which it is to act independently, and its governance arrangements. The framework set out in DOFA (2005) outlines a set of principles for determining the structure and governance arrangements of Australian Government bodies that are broadly consistent with the recommendations of the Uhrig Review (2003). Application of the principles requires that most CAC Act bodies should have a governing board if they undertake predominately commercial operations. The Statement of Expectations (SoE) issued by the minister is intended to clarify the government policies, objectives and priorities that a statutory authority is expected to observe in conducting its operations. CAC Act bodies respond to the SoE with a Statement of Corporate Intent (SCI) which is agreed with their shareholder minister and is required to be tabled in Parliament. The SCI generally sets out the high level strategic objectives and outcomes of the business, including performance indicators. This does not include commercially sensitive information.

The level of ministerial involvement in the operations of statutory authorities varies depending on the objectives and functions of the authority. However, the enabling legislation of most CAC Act bodies provides for the relevant minister to delegate general powers to the governing board to carry out performance of its functions. The legislation governing some CAC Act bodies allows for prescriptive ministerial control of particular aspects, such as entering into contracts and borrowing. For example, the *Terrorism Insurance Act 2003* (Cwlth) stipulates that the relevant minister must provide written directions to the ARPC requiring them to enter into contracts to borrow, or in relation to matters such as the setting of premiums, and the extent to which risk is retained under reinsurance contracts.

Board composition and committees

A common feature of the governance framework of CAC Act bodies is for the shareholder Minister to appoint board members who, in turn, select a managing director or chief executive officer. Consistent with the recommendations of the Uhrig Review (2003), the shareholder minister is not generally represented on the boards of Commonwealth authorities. There are a few exceptions including EFIC, (where the Secretary of the Department of Foreign Affairs and Trade, or an alternate, is a member on the Board (discussed in chapter 9)) the ARPC, the Reserve Bank of Australia and the National Library.[1]

Another common feature of internal governance arrangements of CAC Act bodies, including EFIC, is the use of charters for the board and each of its committees. A charter may define the accountabilities of committee members, provide documentation of delegated authority from the board to executive management and establish procedures for such matters as entering into major transactions or undertaking capital expenditure. For example, the Charter for the Investment Committee of the Board of Medibank Private delegates powers for the Committee to authorise purchases and sales of derivatives to manage its portfolio within risk parameters determined by the Board. According to government business enterprise (GBE) guidelines, the composition and charter of board committees of GBEs should be reviewed annually (Department of Finance and Deregulation 2011).

D.2 Reporting and disclosure

The CAC Act (s. 17) and CAC Act Regulations stipulate the reporting requirements of Commonwealth authorities relating to annual reports and related obligations. A CAC Act body prescribed as a GBE must prepare an annual corporate plan, a publicly available SCI and comply with other aspects of GBE governance arrangements (DOFA 2005).

Corporate plans

Consistent with the requirements of the CAC Act for GBEs, Australia Post and Medibank Private are required to provide corporate plans covering a three-year period to the relevant minister at least once a year. Airservices Australia is a CAC Act body but is not prescribed as a GBE. It produces an annual corporate plan in accordance with its enabling legislation and the CAC Act.

The statutory requirements for tabling and public disclosure of corporate plans vary among CAC Act bodies. EFIC is currently not required to make public its corporate plan. The *Airservices Act 1995* (Cwlth) (s. 15) requires Airservices Australia to table its corporate plan. Australia Post is required under its governing legislation to include in its annual report an outline of strategies and policies as well as performance targets that are set out in the corporate plan.

[1] The *National Library Act 1960* (Cwlth) provides that the Council of the National Library of Australia include a senator elected by the senate and a member of the House of Representatives elected by the House.

The CAC Regulations set out the matters that must be included in the corporate plan of a Commonwealth GBE. These include:

- the objectives of the authority or company
- its investment and financing programs
- financial targets
- dividend policy
- non-financial performance indicators
- community service obligations
- review of performance against previous corporate plans and targets.

In addition to statutory reporting requirements under the CAC Act, most CAC Act bodies are subject to general reporting requirements under their enabling legislation and other legislation such as the *Freedom of Information Act 1982* (Cwlth) and the *Environment Protection and Biodiversity Conservation Act 1999* (Cwlth).

In contrast to the EFIC Act, the enabling legislation of some CAC Act bodies provide for ministerial powers to direct board members, when preparing a corporate plan, to vary the content required, including financial performance indicators. For example, the *Airservices Act 1995* (Cwlth) (s. 14), provides for the responsible minister to direct the Board of Airservices Australia to vary the plan in respect of financial targets and performance indicators relating to the provision of its services and facilities. The *Australian Postal Corporation Act 1989* (Cwlth) (APC Act) provides for the responsible minister to vary Australia Post's strategies to carry out the community service obligations and financial targets that are covered under its corporate plan.

Reporting of financial and non-financial performance indicators

In some instances, the enabling legislation of a government authority sets out the matters to be considered in setting financial targets in annual reports and corporate plans. These include requirements to maintain financial viability and earn a commercial or reasonable rate of return. This generally includes financial indicators such as operating margins, return on equity and dividends to be paid to government.

A comparison of some key financial indicators of the selected CAC Act bodies, including EFIC, for 2010-11 are presented in table D.2. The post-tax return on average equity ranged from 5 per cent for EFIC (commercial account operations) to 18 per cent for Medibank Private.

Table D.2 **Key financial indicators of selected CAC Act bodies**

2010-11

	Units	*Airservices Australia*	*Australian Postal Corporation*	*Medibank Private Limited*	*Australian Reinsurance Pool Corporation*	*Export Finance and Insurance Corporation*
Operating profit[a]	$million	36.4	241.2	299.6	61.4	30.2 (CA) 7.7 (NIA)
Dividend[b]	$million	25.0	78.5	434.4	na	28.7
Dividend as a proportion of total profit	per cent	68.6	32.5	145.0	na	74
Equity[c]	$million	406	1 804	1 585	666	408
Return on average equity[d]	per cent	9.5	13.4	18.1	6.8	5.2 (CA)

[a] Net profit after tax (not including intangibles). Operating profit for EFIC and the ARPC is pre-tax. Operating profit for EFIC is reported separately for the commercial account (CA) and the national interest account (NIA). [b] Dividend for the year ending 30 June 2010 paid the following year. At the date of publication of the 2011 annual report, EFIC's dividend for the year ending 30 June 2011 had not been made. [c] Total equity at end of financial year (including contributed equity, reserves and retained profits). EFIC's equity does not include $200 million callable capital. [d] Post-tax profit as a proportion of average equity. EFIC and the ARPC's return on equity is indicative of the impact of an upper bound tax rate of 30 per cent. This is estimated as 70 per cent of the ratio of pre-tax profit to the proportion of average equity. **na** not applicable.

Sources: Airservices Australia (2011); ARPC (2011a); Australia Post (2011); EFIC (2011a); Medibank Private (2011); Productivity Commission estimates.

In addition to financial performance indicators, the legislation generally also prescribes the non-financial performance standards required to be met by the government agency. For example, in the case of Australia Post, these relate to the frequency, speed and accuracy of its mail services (APC Act, s. 28C). The Auditor General is required to audit and report on compliance with prescribed performance standards and, where these are not met, the Minister may require a service improvement plan (APC Act, s. 28E).

Airservices Australia publishes a service charter which sets out a schedule of services and facilities it provides and establishes a quality of service framework and the measurement metrics against which it reports on performance outcomes. This includes targets for key performance indicators relating to safety, cost effectiveness, capacity, environment and flight efficiency.

Regulation and reporting of pricing

Price regulatory arrangements and reporting requirements differ substantially between government bodies depending on the nature of the services they provide.

As monopoly providers of services, both Airservices Australia and the Australian Postal Corporation are subject to price notification provisions under Part VIIA of the *Competition and Consumer Act 2010* (Cwlth). This applies to the extent that they provide notified services under the Act. The object of these provisions is to apply prices surveillance in relation to markets where, in the view of the Minister, competitive pressures are not sufficient to achieve efficient prices and protect consumers. This requires each body to submit draft price notifications to the Australian Competition and Consumer Commission (ACCC) which are then made publicly available. Regulations under s. 32B of the APC Act allow the ACCC to inquire into disputes about the terms and conditions, including price of access, to Australia Post's bulk mail services. The ACCC also monitors for cross-subsidy within Australia Post's services and may require it to keep certain records.

Medibank Private is able to vary premium rates subject to the approval of the Minister for Health and Ageing. Some provisions of the *Private Health Insurance Act 2007* (Cwlth) may have an impact on the setting on premium rates, for example community rating requirements (under s. 55) and premiums payable under health insurance policies that are part of a premium reduction scheme.

The premium rate charged for reinsurance contracts entered into by the ARPC are determined by ministerial direction having regard to the level of risk. Reinsurance premiums are calculated as a percentage of the premium written by the reinsured company that is attributable to the eligible insurance contract. The percentage rate is set according to the postcode tier in which the eligible property is situated. The ARPC reports its premium structure for different classes of reinsurance and aggregate risk data in its annual report. It also reports this information using an online client information reporting system (box D.1).

Box D.1 **The ARPC Reinsurance Information System**

The Reinsurance Information System (RISe) is the ARPC's client information management system. The RISe allows electronic submission by clients of quarterly and annual returns relating to premium information, as well as submission of claims and loss estimates in the event of a declared terrorism incident. The RISe also allows clients to access information on premium rates and basic market share information. For example, a client (the insurance provider that purchases reinsurance known as the 'cedant') can access information on its market share, which is defined as a percentage of the total aggregate for premiums, exposures and claims in the event of a declared terrorism incident.

Sources: ARPC (2011a; 2011b).

E EFIC’s environmental and social policy

E.1 EFIC’s environmental and social policy and procedure

EFIC has developed a *Policy for Environmental and Social Review of Transactions* (EFIC 2011h) and a *Procedure for Environmental and Social Review of Transactions* (EFIC 2011i), known collectively as the Environmental and Social Policy and Procedure (ESPP). These documents are based on the OECD Recommendation on Common Approaches on the Environment and Officially Supported Export Credits (OECD 2007) and the Equator Principles — Environmental and Social Risk Management for Project Finance (IFC 2006) (box E.1).

Box E.1 **International obligations for environmental and social review**

OECD Recommendation on Common Approaches on the Environment and Officially Supported Export Credits

The OECD Recommendation on Common Approaches on the Environment and Officially Supported Export Credits (OECD Recommendation) sets out common processes to be adopted by OECD Members for environmental review of new projects and existing operations benefiting from officially supported export credits with repayment terms of two years or more.

The processes involve screening applications for officially supported export credits relating to the export of capital goods and services to identify:

- existing operations that are undergoing no material change in output or function in respect of which a Member’s share is greater than SDR10 million
  - These applications may not be classified but should be reviewed before any commitment to provide official support.

(Continued next page)

Box E.1 (continued)

- any new commercial, industrial or infrastructure undertaking at an identified location or to any existing location not covered above (referred to as 'projects').
  - Members should classify all projects in respect of which their share is above SDR10 million and all projects in or near sensitive areas where their share is below SDR10 million.

Projects are classified into one of the following categories according to their potential environmental impacts:

- Category A — the project has the potential to have significant adverse environmental impacts. These impacts may affect an area broader than the sites or facilities subject to physical works and may, in principle, include projects in sensitive sectors or located in or near sensitive areas.
- Category B — the project's potential environmental impacts are less adverse than those of Category A projects. Typically these impacts are site-specific, few if any of them are irreversible, and mitigation measures are more readily available.
- Category C — a project is likely to have minimal or no adverse environmental impacts.

Members should indicate to the parties involved in the project the information required to undertake an environmental review. This includes potential environmental impacts (for example, generation of significant air emissions, effluents, waste or noise, significant use of natural resources, involuntary resettlement, impacts on Indigenous people and cultural property), standards, practices and procedures to be applied by the parties involved in the contract and results of any public consultation with stakeholders.

When undertaking a review, Members should benchmark projects against host country standards and either the relevant aspects of the World Bank's Safeguard Policies or where appropriate, International Finance Corporation (IFC) Performance Standards or other internationally recognised standards (such as European Community Standards) where these standards are more stringent.

To achieve the objectives of the OECD Recommendation, Members should aim to foster transparency, predictability and responsibility in decision making by encouraging disclosure of relevant environmental information but with due regard to any legal stipulations, business confidentiality and other competitive concerns. This requires export credit agencies to publicly disclose:

- their involvement in category A projects and certain project information (including project name, location and description) and environmental impact information, such as input assessments, at least 30 days before a final decision is made to grant official support
- information, including environmental information, on category A and B projects supported during the year.

(Continued next page)

Box E.1 (continued)

Members are required to report to the OECD Working Party on Export Credits and Credit Guarantees at least semi-annually on all category A and B projects for which final commitment has been issued, including reasons for the classification.

Equator Principles

The Equator Principles are benchmarks for financial institutions for determining, assessing and managing environmental and social risk in project finance transactions. They are based on IFC performance standards and are applied where total project capital costs exceed US$10 million and also to all project financing covering expansion or upgrade of an existing facility that may create significant environmental and/or social impacts. Under this framework, participating financial institutions will only provide finance to projects that conform to the Principles. This includes a requirement that, for each project assessed as being either category A or B, the borrower must conduct a social and environmental assessment to address the relevant environmental and social impacts and risks of the proposed project. This may include, where appropriate, an action plan identifying measures required to manage and mitigate the impacts and risks identified in the assessment.

Under certain circumstances, the borrower must publicly disclose information relevant to the assessment and undertake consultation processes to the satisfaction of the lender to establish that concerns of communities that are likely to be adversely affected by the project are addressed.

Sources: OECD (2007); IFC (2006).

The ESPP was revised in 2011 in consultation with non-government organisations (EFIC 2011a). Although the agreements that EFIC must comply with can be narrow in their scope and may be relevant for only some products that EFIC offers (table E.1), EFIC claims to extend the principles embodied in these agreements to all transactions it considers (EFIC 2011i).

Table E.1 **Scope of the OECD Common Approaches and Equator Principles**

EFIC product[a]	*Do the Common Approaches apply?*[b]	*Do the Equator Principles apply?*[c]
Medium–long term finance		
Direct loan (project finance)	Yes	Yes
Export finance guarantee	Yes	No
Documentary credit guarantee	Yes	No
Lines of credit to alliance partner	Yes	No
Supplier credit	Yes	No
Insurance		
Export payments insurance	Yes	No
Bond insurance	No	No
Residual value insurance	No	No
Safety net facility through confirming bank, issuing bank or credit reinsurance	No	No
Political risk insurance (any type)	No	No
Other		
Advance payment bond, performance bond or warranty bond	No	No
Working capital guarantee	No	No

[a] Not a complete listing of EFIC's products and does not include the EFIC Headway working capital guarantee, foreign exchange guarantee, Producer Offset loan, US bonding lines or Risk Participation Agreements. [b] The OECD Common Approaches are only used for transactions with tenor of at least two years. [c] Equator Principles are only used for transactions of at least US$10 million.

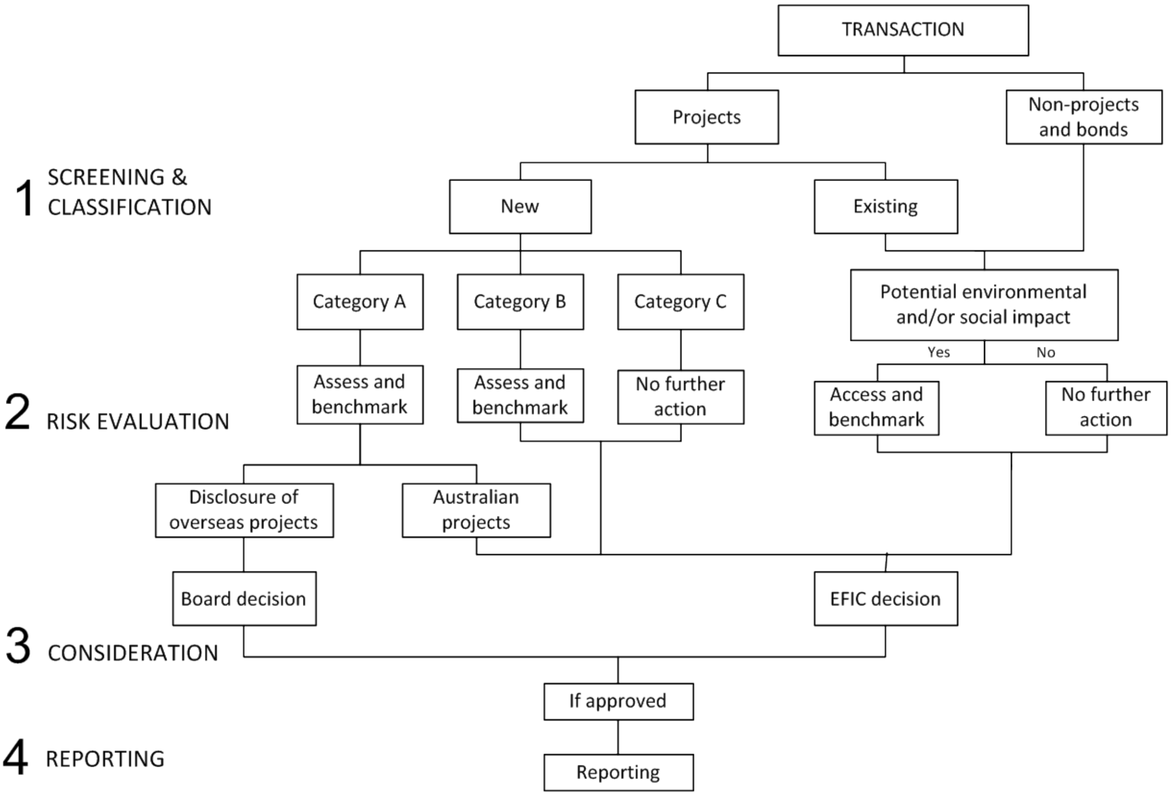
Source: EFIC (2011i).

International agreements provide guidance on how transactions should be assessed for their environmental and social impacts. Under the ESPP:

> The type of support requested, the nature of the project associated with the transaction and the role of EFIC's client determine the type of environmental and social review that EFIC undertakes. (EFIC 2011i, p. 2)

The ESPP involves the screening and classification of transactions (figure E.1). Screening involves determining whether a project is a new or existing project, or a non-project. 'Existing projects' are those where the transaction does not result in a material change in output or function, and 'non-projects' are those where a transaction is not associated with an identified location.

Figure E.1 **EFIC's environmental and social review process[a]**



[a] EFIC does not apply the classification procedure to 'existing projects' (where the transaction does not result in a material change in output or function) or 'non-projects' (where a transaction is not associated with an identified location, such as transactions involving bonds). EFIC has stated that the reason it does not classify these projects is because the client (and therefore EFIC) is unable to assess or influence environmental or social risks.

Source: EFIC (2011i).

EFIC has stated that it uses the guidelines under the Equator Principles to classify new projects for their potential environmental and social impacts. Projects are classified as category A (projects that have potential for significant adverse environmental or social impacts) to category C (minimal or no adverse environmental or social impacts). Category B includes projects that fall between category A and category C (table E.2).

EFIC has stated that category A and B projects are benchmarked against the more stringent of the International Finance Corporation's (IFC) Performance Standards or the host country's standards. Other export credit agencies (ECA), such as US Ex-Im Bank and Japan Bank for International Cooperation, use a similar approach to classify projects.

Table E.2 **EFIC's classification and approval procedure**
New projects only

Category	*Description*	*Procedure*
Category A	Potentially significant adverse environmental and/or social impacts	Assess and benchmark project Public disclosure of some projects is required. Stakeholders can make submissions and EFIC has stated that these are considered as part of the assessment process. The EFIC Board decides whether to accept or reject the project
Category B	Categories A and C represent the two extremes of a project's potential for significant environmental and/or social impacts. Category B transactions fall in the broad spectrum between categories A and C	Assess and benchmark project followed by approval decision
Category C	Minimal or no adverse environmental and/or social impacts	No further risk evaluation. Decision to proceed made by EFIC

Sources: EFIC (2011h; 2011i).

For existing projects and non-projects, EFIC has stated that it undertakes environmental and social risk evaluation based on information provided by the client as part of the due diligence process. If potential for environmental or social impacts is identified, the benchmark will generally be the IFC Performance Standards. However, EFIC may use other internationally recognised standards, host country standards and good industry practice if they consider that they are more appropriate to the proposed transaction.

Under the ESPP, EFIC's potential involvement with new category A projects that meet certain criteria must be publicly disclosed on the category A register on EFIC's website 30 days before a final decision is made. The criteria for category A register disclosure requires that new projects:

- are located outside of Australia
- have repayment term or policy length of two years or more
- have a value of at least SDR10 million[1] (equal to approximately $15 million as of 25 May 2012) unless the project is in a sensitive area, such as a national park (EFIC 2011i).

EFIC also maintains an archive register of EFIC's disclosure of potential involvement in all category A projects, whether the project was supported or not.

[1] The Special Drawing Right (SDR) represents a potential claim on the currencies of IMF members. Its value is based on a basket of international currencies.

EFIC's policy is to disclose supported transactions on a register as soon as practicable after the transaction is signed, including the environmental and social classification of some transactions. EFIC may omit some details that are considered commercially sensitive for a client. Transactions that involve an EFIC Headway working capital guarantee (now discontinued), foreign exchange facility guarantee, Producer Offset loan or Risk Participation Agreement are not listed in the register, although EFIC publishes the total value of these facilities in its annual report.

EFIC does not disclose its potential involvement in projects located in Australia that are subject to the approval requirements of the relevant state or territory government and where appropriate, the Australian Government. This is on the basis that EFIC considers that it does not have the mandate nor does it seek to duplicate these approval processes which include disclosure and consultation processes. EFIC has stated that it still undertakes its own risk assessment of projects located in Australia including whether any approval conditions that apply to a project have any implications for EFIC's transaction (sub. DR90). Where a transaction involves EFIC reinsuring another OECD ECA, EFIC may rely on the disclosure undertaken by that ECA (EFIC 2011i).

EFIC has committed to undertaking an audit of the application of the ESPP by an independent expert every two years with audit reports to be provided to EFIC's Board and made publicly available. The first audit is to be conducted two years following the adoption of its ESPP in 2011.

EFIC has also established a multi-stakeholder forum to facilitate regular dialogue between EFIC and non-government organisations (referred to as civil society organisations) on issues related to EFIC's commitment to upholding best practice environmental and social standards in the transactions it supports.

Anti-bribery measures

As noted in chapter 2, EFIC has stated that it respects a number of international agreements to deter and criminalise bribery and corruption. This includes the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (Anti-Bribery Convention), the OECD Recommendation on Bribery and Officially Supported Export Credits, and the United Nations Convention against Corruption (UNCAC).

The Anti-Bribery Convention requires countries to legislate against the giving or offering of a bribe to a foreign public official to gain or retain a business advantage, and adopt common rules to punish individuals and companies who engage in bribery transactions. The UNCAC requires countries to prohibit their officials from receiving bribes and their enterprises from bribing domestic public officials, as well as foreign officials and officials of public international organisations, and to consider disallowing bribery between private firms. The UNCAC and the Anti-Bribery Convention are intended to be mutually supporting and complementary.

Australia's implementing legislation for the OECD Convention is Division 70 of the *Criminal Code Act 1995* (Cwlth) (Criminal Code Act).[2] The Criminal Code Act applies to the conduct of Australian organisations and imposes criminal penalties for bribery of a public foreign official. However, the Act does not cover conduct between private firms.

The Australian National Audit Office (ANAO) includes assessment of compliance with the Criminal Code Act in relation to bribery of public officials as part of its annual audit of agencies. As part of this process, the ANAO seeks representations from management where there is potential for dealings with foreign officials, as EFIC has, that there are processes in place to ensure compliance with the Act and procedures to undertake inquiries. The ANAO also examines potential allegations relating to Australian Government officials and their agents.

Instances of bribery or corruption may not only be a breach of Australian law, but may also be considered an offence in the country where the alleged bribe is paid, received or promised. For example, Australian businesses operating overseas may be subject to the United States' *Foreign Corrupt Practices Act 1977* (on which Australian law is modelled) and the United Kingdom's *Bribery Act 2010*.

EFIC has stated that, as a member of the Export Credits Group (ECG), it complies with the OECD Recommendation which includes measures to be undertaken by ECG members to deter and combat bribery in connection with officially supported export credits. These obligations, among others, require member ECAs to:

- inform exporters and, where appropriate, applicants, of the legal consequences of engaging in bribery in international business transactions and encourage them to develop, apply and document appropriate management control systems that combat bribery
- require exporters and applicants to provide an undertaking/declaration that neither they, nor anyone acting on their behalf, such as agents, have been engaged, or will engage in bribery in the transaction

[2] The *Criminal Code Amendment (Bribery of Foreign Public Officials) Act 1999* amended the Criminal Code Act to implement the Anti-Bribery Convention.

- verify whether exporters and applicants are listed on the publicly available debarment lists of the following international financial institutions: World Bank Group, African Development Bank, Asian Development Bank, European Banks for Reconstruction and Development and the Inter-American Development Bank
- require exporters and applicants to disclose whether they, or anyone acting on their behalf in connection with a transaction, are currently under charge, or have been convicted within the past five years for violations of laws against bribery of foreign public officials of any country
- require exporters and applicants to disclose upon demand (i) the identity of persons acting on their behalf in connection with a transaction, and (ii) the amount and purpose of commissions or fees paid, or agreed to be paid, to such persons
- inform law enforcement authorities promptly if there is credible evidence at any time that bribery was involved in the award or execution of an export contract
- refuse to provide support for a transaction if there is credible evidence that bribery was involved in the award or execution of a contract, or if due diligence concludes that bribery was involved in the transaction (OECD 2006a).

EFIC is a member of Transparency International Australia, part of a global not-for-profit, non-government organisation focused on curtailing corruption.

EFIC has established Anti-Corruption Policy and Procedures to manage its compliance with Australian law and the Anti-Bribery Convention (EFIC ndb). These describe its application of anti-corruption measures relating to management control systems, staff roles, responsibilities and training, decision making, record keeping, reporting and corruption allegation procedures. These policies and procedures are periodically audited by EFIC's internal auditors (EFIC, pers. comm., 18 April 2012).

E.2 Application of the Environmental Protection and Biodiversity Conservation Act

Section 28 of the *Environmental Protection and Biodiversity Conservation Act 1999* (Cwlth) (EPBC Act) prohibits the Australian Government or an Australian Government agency (such as EFIC) from undertaking 'an action that will have or is likely to have a significant impact on the environment inside or outside Australian jurisdiction'. This is unless the action is exempted by the Minister responsible for the EPBC Act in certain circumstances (such as national security and emergency) or the action is exempt or approved under the framework established by the EPBC Act.

An action is broadly defined[3] and includes:

> … construction, expansion, alteration or demolition of buildings, structures, infrastructure or facilities; storage or transport of hazardous materials; waste disposal; earthworks; impoundment, extraction and diversion of water; research activities; vegetation clearance; military exercises and use of military equipment; and sale or lease of land.
>
> Actions encompass site preparation and construction, operation and maintenance, and closure and completion stages of a project, as well as alterations or modifications to existing infrastructure. (DEWHA 2010, p. 1)

Section 160 of the EPBC Act requires an Australian Government agency or employee to obtain and consider advice from the Minister for the Environment before authorising one of the following actions:[4]

- entry into a contract, agreement or arrangement for the implementation of a project under Australia's foreign aid program that is likely to have a significant impact on the environment
- adoption or implementation of a plan for aviation airspace management involving aircraft operations that are likely to have a significant impact on the environment
- the adoption or implementation of a major development plan (as defined in the *Airports Act 1996*)
- an action authorised by a permit under the *Environment Protection (Sea Dumping) Act 1981*
- an action authorised by a Basel permit, or by a variation of a Basel permit, under the *Hazardous Waste (Regulation of Exports and Imports) Act 1989*
- an action authorised by a grant, renewal or variation of a permit or the grant of an exemption certificate under the *Sea Installations Act 1987*
- an action authorised by a permit or authority under the *Wildlife Protection (Regulation of Exports and Imports) Act 1982.*

EFIC has supported some projects that are subject to ministerial approval under the EPBC Act. For example, it provided an export finance guarantee for the Wiggins

[3] An 'action' under the EPBC Act includes a project, development or undertaking, an activity or series of activities, or an alteration of any of these (EPBC Act, s. 523).

[4] A decision by a government body to grant a governmental authorisation (however described) for another person to take an action is not defined as an action (EPBC Act, s. 524).

Island coal export terminal development at the Port of Gladstone.[5] More recently, EFIC, along with two other ECAs, has provided debt facilities to fund the development of a liquefied natural gas processing facility at Gladstone.[6]

EFIC's involvement in such projects does not constitute it being a proponent of an action subject to referral, assessment and approval requirements of the EPBC Act. The provision of products by EFIC to support export projects are neither actions which are subject to s. 28 of the EPBC Act, nor actions under s. 160 of the Act that would require EFIC to obtain and consider advice from the Minister for the Environment prior to granting governmental authorisation. There is no mechanism under the assessment processes of the EPBC Act that requires EFIC to disclose its involvement in onshore and offshore projects. This is with the potential exception of those transactions which have a significant foreign aid component that would constitute EFIC making an authorisation to enter into a contract, agreement or arrangement under s. 160(2) of the Act.

As an Australian Government agency, EFIC has a statutory requirement under s. 516A of the EPBC Act to report on environmental matters in its annual report which includes identifying:

- how its activities accord with the principles of ecologically sustainable development[7]
- how its outcomes for the period contribute to ecologically sustainable development
- the effect of its activities on the environment
- any measures taken to minimise the impact of these activities on the environment
- the mechanisms in place for reviewing and increasing the effectiveness of measures.

EFIC has stated in its annual report that it fulfils these statutory requirements for reporting on its environmental performance in two parts:

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5 In 2008, ministerial approval was given to the Central Queensland Ports Authority and Queensland Rail to develop the terminal and associated infrastructure, which was subsequently transferred to the Gladstone Ports Corporation in 2011 (SEWPaC 2011).

6 In 2010, ministerial approval was given for the development, construction, operation and decommissioning of a liquefied natural gas facility and associated onshore facilities within the Curtis Island Industry Precinct at the Port of Gladstone (SEWPaC 2011).

7 Activities include developing and implementing policies, programs and legislation and the operation of the agency (EPBC Act, s. 516A(7)).

- The ESPP describe how environmental and social issues are considered in the provision of EFIC's services to exporters.
- EFIC's direct environmental performance is measured using indicators of the environmental footprint of its operations, such as business travel, energy use, water use and wastewater generation associated with office facilities. (EFIC 2011a).

As previously discussed, EFIC undertakes an environmental and social risk evaluation of all transactions based on the ESPP. It discloses its prospective involvement in new projects that are considered to have potentially significant adverse environmental and social impacts (classified as category A projects that meet certain criteria). However this does not include disclosure of all the facilities it provides or projects it supports.

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