Australian Government

EFIC

Export Finance & Insurance Corporation

Submission to the Productivity Commission

Appendix A

Response to the Productivity Commission's 'Issues Paper'

This paper responds to the questions in the Productivity Commission's 'Issues Paper', which can be found at: http://www.pc.gov.au/projects/inquiry/export-credit/issues. It follows the format and headings of the Issues Paper and is numbered for ease of navigation.

Level 10 Export House, 22 Pitt St. Sydney NSW 2000 Australia
PO Box R65 Royal Exchange NSW 1223 • ABN 96 874 024 697
Phone +61 2 9201 2111 • Fax +61 2 9251 3851 • efic.gov.au

Export Finance & Insurance Corporation

Financial performance and supported exports

1. *Bearing in mind EFIC's exemption from competitive neutrality and explicit government guarantee, how does EFIC's financial performance compare to that of the private sector for similar levels of risk? Is it appropriate to compare EFIC's financial return to that of the private sector?*

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.

In an international context, ECAs have differing mandates and therefore comparison of financial performance is difficult, compounded by the fact that there is little relevant public data to draw valid financial comparisons.

Despite these differences some comparisons can be drawn. The KPMG 'Financial Institutions Performance Survey' gives key financial ratios for Australian banks that can be useful as a benchmark for EFIC.[1] The financial ratios in the graphs below show EFIC in comparison to both the four major Australian banks (ANZ, CBA, NAB and Westpac) and the four Australian regional banks (BOQ, Bendigo, Adelaide Suncorp and Members Equity). Whilst noting its different mandate, EFIC is comparable to the regional banks in terms of size. EFIC compares favorably on a number of measures.

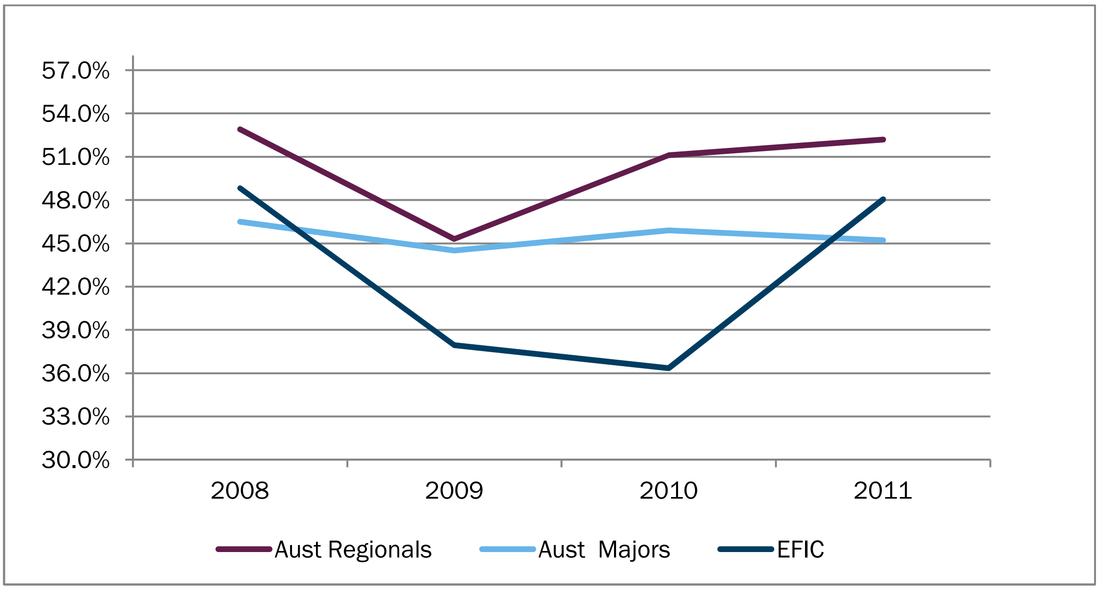
Cost to Income

EFIC's cost to income ratio has ranged from 36.3% to 48.8% over the last four years. This is consistently below that of the regional banks. EFIC's costs (the numerator) have been relatively stable over this period while the net income figures (the denominator) have been impacted by volatility in financial markets, resulting in variances in the cost to income ratio from year to year.

By way of example, one of the major variable income drivers is the 'allowance for credit risk'. In 2011, EFIC increased the allowance for credit risk by A$14.8 million, while in 2010 it released A$11.5 million of allowance for credit risk. This A$26.3 million difference has a major effect on the cost to income ratio from 2010 to 2011, while operating costs have increased a maximum of A$3.2 million (15.5%) over the last four years which has had a lesser effect on the ratio reported below.

[1] See KPMG Financial Institutions Performance Survey' available at:
http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Financial-Institutions-Peformance-Survey/Pages/default.aspx

Figure 1: EFIC cost to income ratio (% pa) vs. Australian regional and major banks

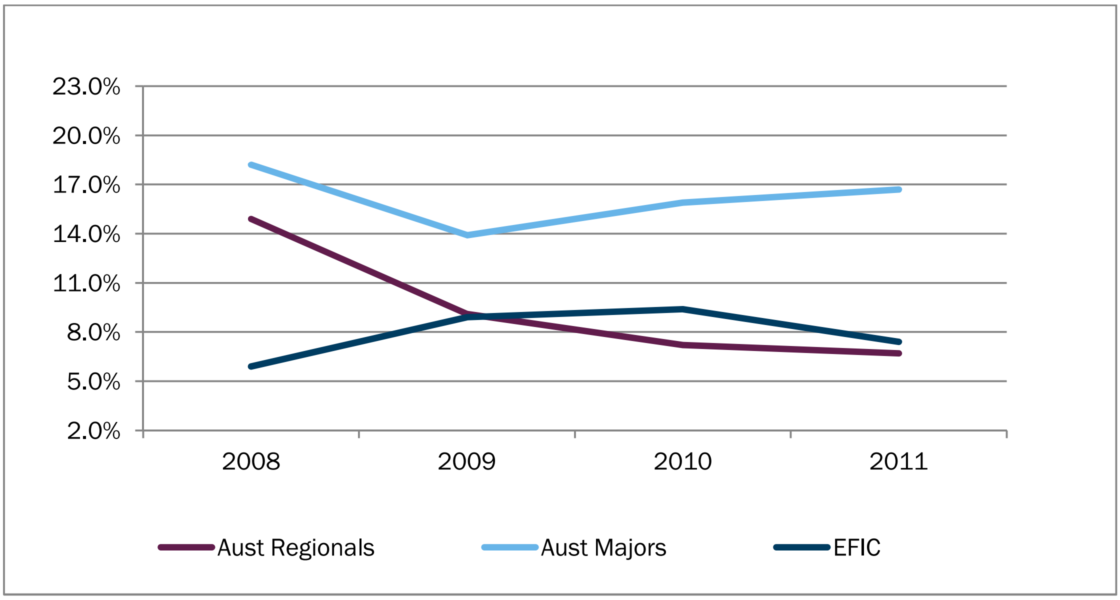


EFIC has compared well with regional banks who averaged from 45.3% to 52.9% cost to income ratio over this period.

Return on Cash Equity

EFIC's return on cash equity has been in the range of 5.9% to 9.4% from 2008 to 2011. The regional banks have averaged a similar range to EFIC except for 2008 where they reported a higher return on equity ratio. As shown in the below chart after the onset of the global financial crisis (GFC) in 2008, both the regional and major banks had a significant reduction in their return on equity (ROE) ratios. During the same time period EFIC's ROE ratio actually increased and has remained relatively stable since.

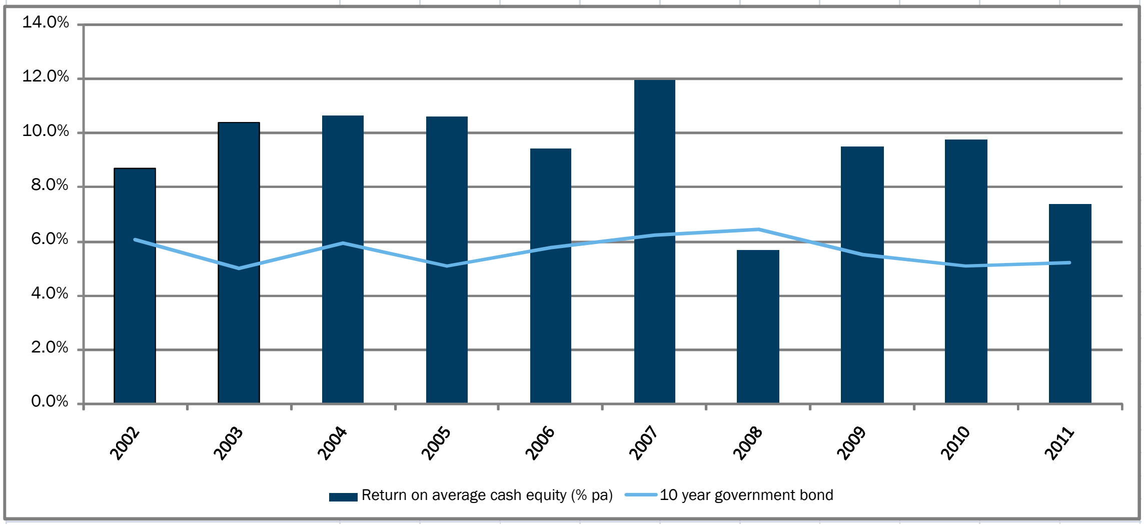
Figure 2: EFIC return on cash equity (% pa) vs. Australian regional and major banks



Aside from 2008, EFIC has constantly had a ROE ratio higher than the 10-year Government bond rate which can be used as a proxy for the risk free rate of return. As noted above, one of the major variable income drivers is the 'allowance for credit risk.' In 2008, EFIC increased the allowance for credit risk by A$17.9 million due to significant drawdown on facilities signed in previous years which reduced operating profit and therefore had an impact on the ROE ratio in that year.

Figure 3: EFIC return on cash equity (%pa) vs. 10-year government bond rate (%pa) 2002-2011

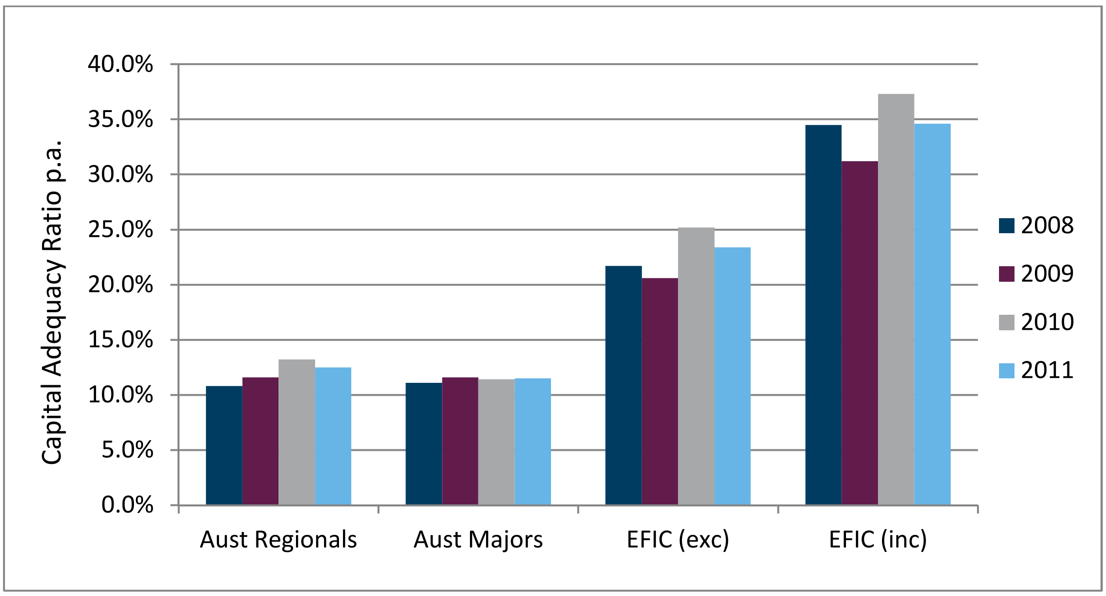
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Operating profit of the Corporation	19.4	25.5	27.7	29.4	28.7	40.7	19.7	33.6	38.3	30.2
Cash Equity	237.9	253.7	266.2	287.5	321.7	359.8	331.2	376.7	407.6	408.1
Return on average cash equity (% pa)	8.7%	10.4%	10.7%	10.6%	9.4%	11.9%	5.7%	9.5%	9.8%	7.4%
10 year government bond	6.1%	5.0%	5.9%	5.1%	5.8%	6.3%	6.4%	5.5%	5.1%	5.2%



Capital Adequacy Ratio

From 2008 to 2011, EFIC's capital adequacy ratio has ranged from 31.2% to 37.3% including A$200 million callable capital and from 20.6% to 25.2% excluding callable capital. This ratio has dropped in the last twelve months due to a higher level of risk weighted assets (RWAs) on EFIC's account at the same time as its stable capital position from 2010 (A$417.4 million) to 2011 (A$418.8 million).

Figure 4: EFIC capital adequacy ratio (% pa) against Australian regional and major banks



EFIC's policy is to maintain a minimum 16% capital adequacy ratio due to its higher risk concentrations. Given this minimum, it should be expected that EFIC's capital adequacy ratio will be higher than the banks.

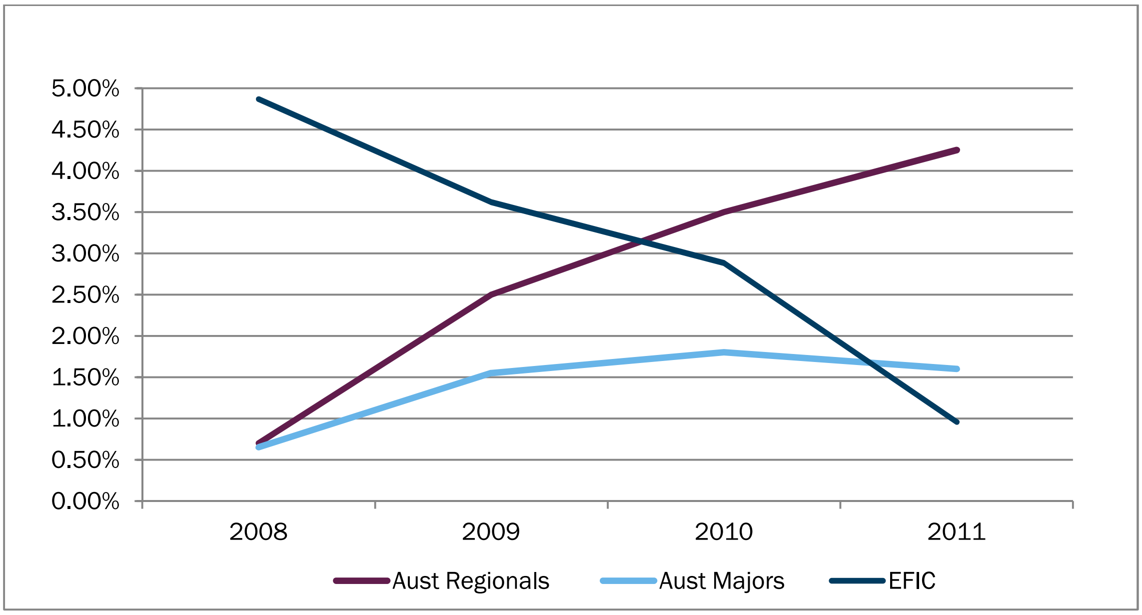
Multilateral organisations with comparable risk profiles to EFIC also typically operate with much higher capital adequacy ratios than banks. For example the Asian Development Bank (ADB) operates at 28% and the International Finance Corporation (an arm of the World Bank) operates at a level in excess of 40%.

It should be noted that EFIC, the regional and major banks all use different calculation methods for assessing capital adequacy under the Australian Prudential Regulation Authority (APRA) guidelines.

<u>Gross impaired assets as a % of on-balance sheet risk weighted assets (RWA)</u>

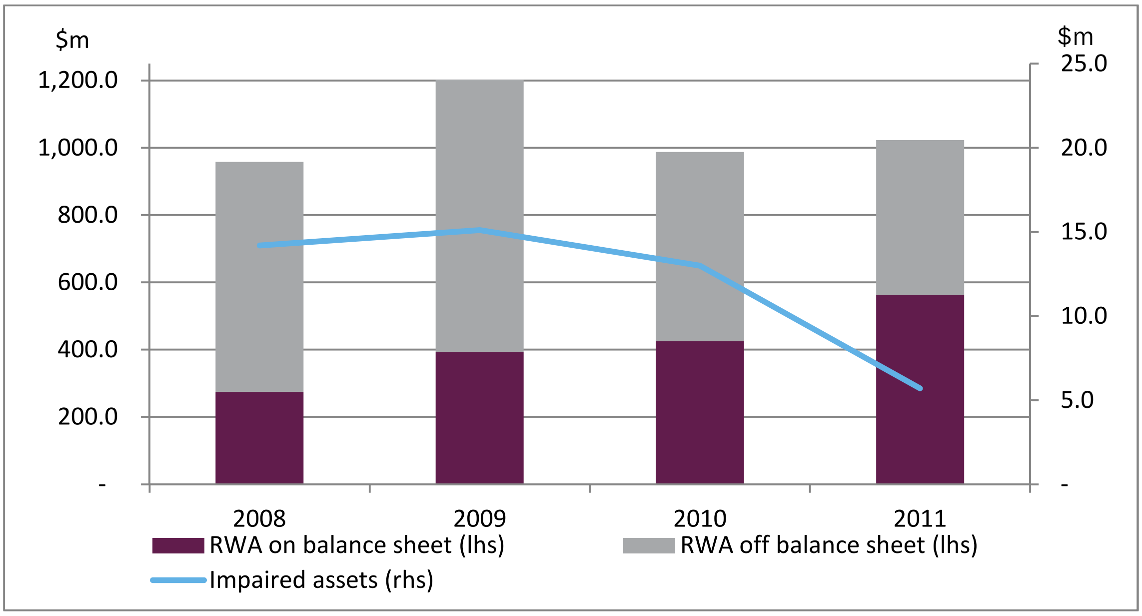
EFIC's gross impaired assets as a percentage of on-balance sheet RWA has improved i.e. the ratio has fallen over the last four years to historic low levels. This indicates that EFIC has managed the risk in our portfolio well over the past few years but it also highlights the relatively small number of problem facilities on EFIC's books.

Figure 5: EFIC gross impaired assets as % of on-balance sheet RWA



When looking at Figure 5, the ratio has declined because gross impaired assets have fallen (the numerator) and on-balance RWA have risen (the denominator). Figure 6 below illustrates this more clearly and shows the decrease in $million in the level of gross impaired assets (A$15.1 million to A$5.7 million) at the same time as the level of on-balance sheet RWA has grown (A$275.1 million to A$562.6 million).

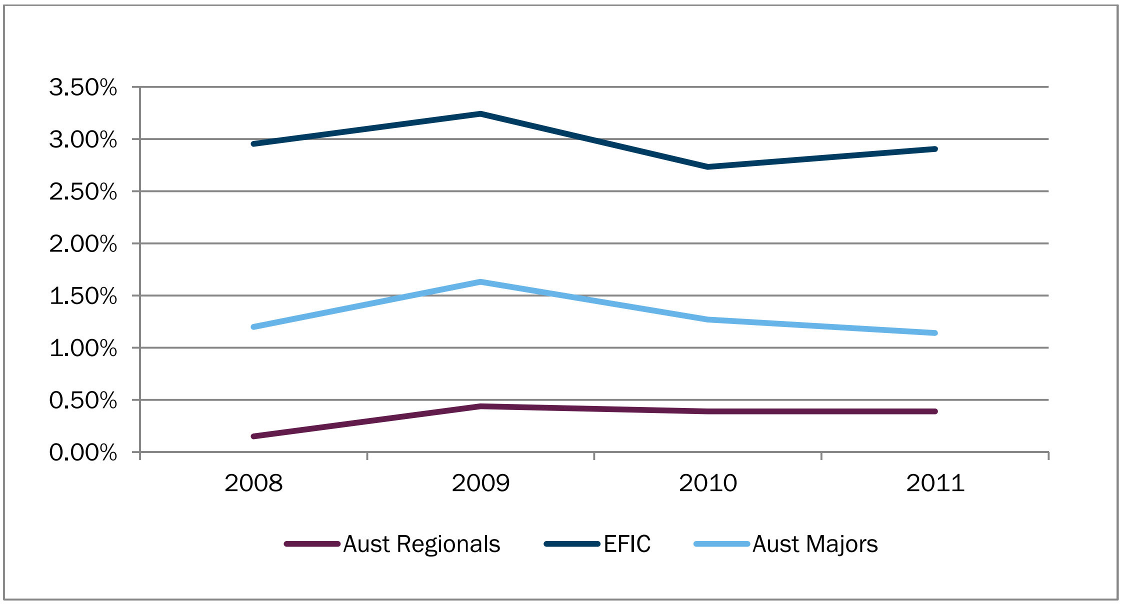
Figure 6: EFIC on-balance sheet RWA vs. Gross Impairment



Provision cover as a percentage (%) of RWA

EFIC has averaged around 3% general provisioning (allowance for credit risk) as a percentage of RWA over the past four years, while the majors have averaged 1.5% and the regionals 0.5%. EFIC, as a market gap operator with higher levels of concentration risk in its portfolio, would be expected to report a higher ratio than the banks, as shown in Figure 7 below. As highlighted earlier, the majors and regionals have a more diversified portfolio including residential mortgages which have a lower RWA weighting.

Figure 7: EFIC allowance for credit risk as percentage of RWA



2. How should the Government set its return expectations and communicate them to EFIC?

EFIC is required to provide the Minister for Trade with a 'Statement of Intent' (SOI) in response to the Minister's 'Statement of Expectations' (SOE). The SOE is the means by which the Minister for Trade communicates his expectations to EFIC's Board.[2]

EFIC's Key Performance Indicators (KPIs) and business expectations, including target return ratios, are detailed in EFIC's annual corporate plan which is approved by the Board (including the Government member). EFIC consults DFAT in the preparation of the corporate plan and the draft plan is provided to the Minister for Trade.

In addition, Government is informed of EFIC's financial and business results through the EFIC's Annual Report which is tabled in Parliament. DFAT is consulted during the preparation of the Annual Report and the draft Annual Report is provided to the Minister for Trade.

EFIC's Chief Financial Officer also meets with DFAT and Central Agencies at least annually, to present EFIC's financial and business results.

The EFIC Board notifies the Minister in writing each year of its recommendation regarding the payment of a dividend. The Minister has ultimate discretion whether that recommendation is followed, or a direction is made for an alternative amount.

Rationale for Government intervention

3. What are the broader rationales for assisting Australian exporters? Which of those rationales are most consistent with EFIC's operations? What is the evidence that intervening on that basis generates a benefit to the community?

In general terms, research has shown that, on average exporting companies are more profitable than their non-exporting counterparts. Exporting exposes firms to new ideas, management practices, technology and ways of competing. This increases productivity and lifts firm competitiveness both domestically and internationally. It also provides an opportunity for exporters to diversify from a single market and achieve economies of scale.[3]

There are inherent risks and challenges associated with cross-border trade that do not necessarily exist, or exist to the same extent, in non-export operations such as lack of information about risk counterparties and inherent political and country risks associated with foreign markets. These factors form part of the broader rationale for assisting Australian exporters where the private market is unwilling or unable to do so in cases where a transaction is considered commercially viable and satisfies appropriate credit and due diligence criteria.

In economic terms, in the absence of market failure the unfettered market will achieve the right balance between export and non-export industries and any government intervention to tilt the balance towards exports involves net costs rather than net benefits. The strongest rationale for

[2] See Statement of Expectations and Statement of Intent at: http://www.efic.gov.au/about/governance/Pages/Principalaccountabilities.aspx
[3] See Austrade: http://www.austrade.gov.au/How-to-export/default.aspxt and the 2008 independent Review of Export Policies and Programs undertaken by D Mortimer AO and J Edwards: 'Winning in world markets: Meeting the competitive challenge of the new global economy': http://www.dfat.gov.au/publications/mortimer_report/index.html

government support for exporters is to fix market failure. Furthermore, government support to address market failure can bring costs as well as benefits: benefits in the form of additional exports; costs in the forms of forgone output in non-export industries and contingent liability of federal accounts. In seeking to address a market failure, government must select the intervention that most directly targets the failure.

Failures exist in the market for export finance and insurance that lead banking and capital markets to under-support exports and overseas investment relative to the social optimum. These are failures that an ECA such as EFIC can efficiently correct. In addition, EFIC as a government-owned statutory corporation has some inherent features that enable it to support profitable exports and investment that would otherwise not occur.

There are at least four market failures that beset the markets for export finance and insurance: credit rationing, contractual problems, externalities of financial disruption and artificially scarce information.

1. Credit Rationing

Economists have recognised that credit markets can fail to clear through interest rate adjustments.[4] There can instead be excess demand for funds, otherwise known as credit rationing. This is not a disequilibrium anomaly caused by 'sticky' interest rates that will correct itself quickly. It is rather a characteristic of the credit market equilibrium, traceable to the fact that (to cite Stiglitz and Weiss):

> *"... 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 ... 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."*

In these circumstances, a bank may prefer to 'screen out' excess loan applicants by holding the interest rate in check and requiring collateral rather than charge a higher interest rate. That way it is more likely to attract 'good borrowers' (Stiglitz and Weiss's term) with sound investments and strong repayment ability. Charging a higher interest rate, by contrast, could be self-defeating, because it encourages 'bad borrowers' to step forward and 'good borrowers' to step back; the higher interest rate could actually undermine the lender's profit.

If such rationing only screened out 'bad borrowers', there would be no problem. However banks may also deny loans to borrowers who are 'observationally indistinguishable' from those who receive loans; some could in fact be 'good borrowers'. 'Thus', say Stiglitz and Weiss, 'there can be no presumption that the market equilibrium allocates credit to those for whom the expected return on their investments is highest'.

If 'good investments' go unfunded because of credit rationing, there is a potential role for government to play in financing such investments.

EFIC provides support for exporters who are 'good borrowers' but who are initially screened out by the private market. It can do so on the basis of its capabilities in country risk and technical assessments and its willingness to support cash flow lending. Clearly, prudence is needed because

[4] See paper by J Stiglitz and A Weiss, Credit Rationing in Markets with Imperfect Information, *American Economic Review*, 71(3), June 1981, pp. 393-410.

there are often good reasons for a bank to deny a would-be borrower funding. But EFIC has demonstrated such prudence through its lending and risk management procedures (see response to Q49), and above all through its track record of stable financial performance (see response to Q1).

2. Cross-border contractual problems

In an uncertain world it can be difficult to write water-tight contracts covering all possible future contingencies. As a result, a sub-optimal amount of trading, including risk trading, can occur. This argument is particularly applicable to the export finance and insurance markets, where commercial risk events are difficult to distinguish from political risk events, so in the event of a claim the policyholder can get drawn into a legal wrangle. In the face of this uncertainty, a company may decide that insuring and doing the underlying business is too difficult.

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.

3. Externalities of financial disruption

An ECA can perform a particularly important service during a financial crisis. It can step forward in support of exports as the private sector steps back, thereby cushioning a slump of exports. In a financial crisis it might be argued that private sector retrenchment is a rational reaction to heightened risk. Therefore, the ECA's increased activity could be perceived as reckless and bound to lose money. However, this is not necessarily the case, if externalities and other market failures prevent markets from making rational calculations during financial crises.

Economists recognise that externalities can come into play during a financial crisis, and each can lead to irrational private decision-making that in turn causes great waste. This is not the waste of resource misallocation within a fully-employed economy – a waste that can often be small-moderate. It is rather the 'Keynesian' waste associated with large slumps in production and trade, and the extensive retrenchment of labour and capital that comes in their wake. The resultant unemployment can be very costly and leave lasting problems, such as deskilled and de-motivated workers for example. Joseph Stiglitz, the economist who has probably done the deepest analysis of failure in financial markets, states that:

> *"The macroeconomic consequences of disruptions of the financial system provide one of the more important rationales for government intervention.[5]"*

Among the externalities and other market failures that can arise in times of financial and economic crisis and cause a trade credit slump, and consequent trade and production slump, are asymmetric information and the short term nature of trade finance:

- Asymmetric information: Economists have long recognised asymmetric information as a source of market failure. Information about trading is costly to obtain and during a financial crisis these already high costs can soar and cause a collapse of trust. Information about

[5] Joseph E Stiglitz, 'The Role of the State in Financial Markets', March 1994, p. 26, www.josephstiglitz.com

- foreign counterparty risk becomes especially hard to get. In these circumstance banks become cautious, and refuse point-blank to accept and discount foreign bank letters of credit or promissory notes from foreign importers.
- Short term nature: The short term nature of much trade finance is a second possible cause of market failure. Banks desperate for liquidity or to reduce credit exposure rush to cut shortly-maturing trade credit lines even though trade finance is considered relatively safe thanks to its collateralisation and/or short term self liquidating nature.[6]

Because of these types of externalities, trade credit can be unfairly singled out during a financial crisis, and as a consequence economies can suffer from import shortages, export slumps and idled resources. This is precisely what happened in the GFC of 2008-09, the Latin American financial crisis of the early 2000s, and the Asian financial crisis of 1997-98. Reduced interbank trust during each episode crunched the acceptance and discounting of letters of credit from overseas banks, which in turn crunched trade flows. Some of this retrenchment was justified by the increased illiquidity and reduced solvency of overseas banks, but not all of it, as good banks were treated the same way as bad banks. In 1997-98, bank-financed trade credit fell by about 50% in Indonesia and 80% in Korea. During the Latin American crisis, trade credits in Argentina and Brazil declined by as much as 30-50%.[7]

Not only did crisis-afflicted countries find it hard to import as a result, but Australian exporters had corresponding difficulty exporting.

When ECAs such as EFIC stepped in to guarantee foreign bank letters of credit they were able to cushion the contraction of bank-financed trade credit, and hence cushion the fall in foreign trade. During the course of the Asian Crisis in 1997-1998, EFIC supported over $15 billion worth of exports over those two years. Special facilities were made available by the Australian Government under the NIA for exports to key markets, which were particularly hit during the crisis, including Korea and Indonesia.

4. Artificially scarce information

Market information is a public good, which means that once produced it can be made freely available to everyone at no, or virtually no, additional cost. However, even though it can be made freely available, it won't be if left to the private marketplace. In fact private producers will charge a high price and restrict supply. They will charge a high price, because they need to make money and they often have high overheads, if not high marginal costs, that need to be recovered from sales revenue. The high price that is charged will create an artificial scarcity that undermines efficient resource allocation and public well-being. If the market information or public good could be made more freely available, society would incur little extra cost, but there could be considerable benefit for additional consumers. This would be a clear social gain.

EFIC plays a role in alleviating an artificial scarcity of information about country risk, by freely disseminating various country risk assessments and briefings. This makes businesses better informed about country risk and additional profitable exports and investment can be brought forward as a result. The Government's April 2011 Trade Policy Statement makes a similar argument in support of Austrade providing free information on emerging and frontier markets:

[6] Jean-Pierre Chauffour and Thomas Farole, 'Market adjustment versus market failure', *Trade Finance During the Great Trade Collapse*, Jean-Pierre Chauffour and Marriem Malouche eds, World Bank, 1991
[7] Ibid, p13

"Market information is a public good: the use of the information by one firm does not reduce the total amount of information available to others. Left to private markets, the search costs that would need to be borne by a single firm, particularly in an emerging or frontier market, can be prohibitively high. Just as a government can correct for market failure in mineral exploration by conducting early geological survey work and disseminating the information obtained to all private exploration firms, there is a legitimate role for government in generating information in emerging or frontier markets and disseminating this freely to interested firms.

The strongest rationale for government support for trade and outward investment promotion therefore is one of addressing market failure. There is a far less compelling case for government to promote and assist exporters generally in the absence of market failure.

The most obvious information deficiencies are in emerging, frontier and transitional economies; where governments play a significant role in the economy; where language and business culture can provide a barrier; where there may be less openness of regulatory frameworks and transparency of business processes; where there are greater difficulties accessing distribution channels and commercial connections; and where the value of the 'badge of government' is highest. Austrade's trade promotion activities will be reoriented towards these markets."[8]

These arguments apply just as much to EFIC as to Austrade. It could be argued that they apply more strongly to EFIC when it comes to country risk assessment; Austrade has comparative advantage when talking about business opportunities in emerging markets, but EFIC has an advantage in the analysis of risk in these markets.

Unique Features of ECAs:

Apart from fixing market failures there are a number of features that enable ECAs to support profitable exports and investments that would otherwise not have occurred, such as: (1) information (2) risk-bearing potential, (3) capacity to control risk, (4) a solid reputation, and (5) first-mover advantage.

1. **Informational advantage**

An ECA's closeness to government may also give it an informational advantage over the private sector. One of the greatest impediments to providing insurance for medium and long-term export finance is the difficulty of quantifying the probability of loss into the future. This difficulty can prompt a bank or insurance company to brand as 'too hard' proposals for export finance or PRI that it would actually assess as profitable if it knew the 'true' risk. Potentially profitable export and investment is therefore lost.

But an ECA with access to government information can do 'truer' country risk assessments and it can discern such profitable deals. In addition to access to information through government, this expertise arises out of institutional experience, networks of international ECAs, international fora including the Berne Union and the OECD, as well as the private market.

One way an ECA can get this information out into the marketplace is to 'sanitise' it and disseminate it as discussed above under 'Artificially scarce information.' But sanitisation might not always be

[8] www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.html

possible. If not, the ECA might have to engage in 'signalling'. Signalling is a way for parties to a contract to overcome problems of asymmetric information. In the case of an ECA, it 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.

Through all of these signals, an ECA can induce profitable exports that the market left to its own devices could not.

2. <u>Risk bearing</u>

There is broad recognition that risk markets can be especially prone to fail. The Treasury, whose mission is to 'improve the well-being of the Australian people, has developed a well-being framework to guide it in carrying out its mission. The framework identifies five dimensions of well-being. Risk is one – alongside opportunity, consumption, distribution and complexity. Treasury notes that:

> *"All else being equal, it would be expected that well-being would be improved if there is a better match between people's risk preferences and the risk borne ... An optimal allocation can be achieved by facilitating full risk-trading among complete markets. This suggests that addressing risk market failures ... provides a potential agenda for future economic policy reform to improve well-being. However, since risks and resources are inextricably linked each potential intervention needs to be assessed in terms of its resource impacts as well is it risk impacts."*[9]

Accordingly, it may be reasonable to presume markets are efficient until proven otherwise, but it must also be acknowledged that risk markets – the ones in which EFIC operates – can and do frequently fail, and can be improved upon by government intervention.

Malcolm Stephens in his 1999 review of ECAs for the IMF[10], the consultancy NERA in its 2000 review of ECGD[11] and the Bundesbank in a study of Euler Hermes in 2006[12] argued that government may be better placed than private markets to bear the risks associated with export finance and insurance. They had two reasons. First, those risks are often large, long-term and positively correlated (LLPC). 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.

For a major proportion of ECA business the risks are large because they often concern large infrastructure, engineering and capital goods projects. They are long because the credits involved can only be repaid over an extended period as the projects they finance generate returns. The risks are positively correlated because the exposures are often to politically risky countries and governments. If one of these countries gets into trouble so do most of its obligors. There can also be contagion between countries, amplifying the risk correlation.

---

9 www.treasury.gov.au/documents/876/HTML/docshell.asp?URL=Risk_wellbeing_public_policy.htm
10 www.imf.org/external/pubs/cat/longres.cfm?sk=3014.0
11 http://webarchive.nationalarchives.gov.uk/tna/+/http:/www.ecgd.gov.uk/nera.pdf
12 www.bundesbank.de/download/volkswirtschaft/dkp/2006/200636dkp.pdf

In addition, political risk is not amenable to actuarial calculation in the way that heart disease or motor accident risk is. It can be idiosyncratic and evolutionary. In other words, the past record of political risk events may not be a good guide to the future.

If a government has a strong investment grade credit rating, it can take on additional risk to a far greater extent than a private company (even one with an equivalent rating) without endangering its credit standing and pushing up its borrowing costs. Finally, 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.

In conclusion this does not mean EFIC should finance or insure projects with negative expected net present values (NPVs). However, it does mean that EFIC, with the National Interest Account (NIA) standing behind it, can support profitable but LLPC transactions and investments that the private market alone might struggle with.

3. Risk control

It has also been argued, including by both NERA and the Bundesbank that an ECA can better control the country risks it is assuming than a private sector counterpart, due to the diplomatic and financial links of its government owner. The government may also have an advantage over the private sector in recovering loan losses and insurance claims. This might be either because it has direct influence over the foreign government, or because it can act in concert with other official creditors in influential multilateral bodies like the Paris Club.

In some cases the government owned ECA doesn't have to take overseas country risk as it finds it, but can take steps to reduce risk, or recover more money. By reducing risk it can promote profitable trade and investment above and beyond what the private sector can achieve and be profitable in the process.

4. Reputation

Exporters see ECAs, particularly established ones, with sound records, backed by investment grade governments, as having a reputation to uphold. ECAs won't reject claims unnecessarily and importantly would not get into a position where they could not pay a claim. In contrast, exporters may view a private company with some suspicion, given the LLPC risks that typify the export finance and PRI markets.

5. Existing infrastructure

EFIC represent an investment in 'soft infrastructure' built up over 50-plus years. This includes export and financial markets knowledge and expertise, international networks of private and government export credit providers, policy expertise through contributions to OECD[13] and Berne Union[14] forums, and up-to-date knowledge of pricing benchmarks and terms and conditions of support. The exact value of this soft infrastructure is difficult to determine, however it enables EFIC to provide support profitably in cases where the private sector cannot. It is also critical, particularly in times of crisis, to assist in maintaining the flow of credit to exporters, and to provide Government with valuable information on market dynamics and developments. While this is not a unique feature of ECAs it

---

[13] Australia is a 'participant' to the Organisation for Economic Cooperation and Development's (OECD) Arrangement on Export Credits and also participates in the Export Credit Working Group. See: http://www.oecd.org/department/0,3355,en_2649_34169_1_1_1_1_1,00.html
[14] The Berne Union is the international association for export credit and investment insurance industry. See: http://www.berneunion.org.uk/index.html

does imply that careful consideration should be given before deciding to disband an established ECA and thereby lose these capabilities.

Commercial Account

Determining the Market Gap – a top-down approach

4. How should the market gap be determined?

Typically each proposal that EFIC receives is unique from a market gap perspective; however there are some common elements and therefore common criteria that are applied to help determine if a market gap exists. As agreed by Government in the context of the 2006 Review, EFIC forms a view on whether there is a market gap based on considerations of:

- Risk: for example, country or project specific risks.
- Size: whether the project's size affects commercial market participation i.e. too small or too large relative to commercial market limits.
- Term: a facility with a longer term will be more likely in the market gap than shorter tenors.
- Industry: for example, a developing industry or green-field development, or an industry with an inherent high risk profile e.g. involving concessions or contracts with emerging market host governments.
- 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.

EFIC's consideration of the market gap is informed by a range of information sources, including:

- Bank and insurer contacts: including from both domestic (informally and also through bodies such as the Australian Trade Finance and Insurance Association (ATFIA)) and foreign sources. When considering whether an export is in the market gap EFIC may crosscheck information from other private market sources.
- Clients: EFIC receives information from clients regarding the availability of finance; information is corroborated with the private market,
- Berne Union data and reporting: as well as informal discussion amongst members,
- OECD reporting and discussion: as well as informal discussion amongst members,
- Other information sources: EFIC is a member of Asia Pacific Loan Market Association and contributes to the Project Finance committee.

A further test of whether EFIC is operating in the market gap, and not encroaching, or crowding-out the private sector is whether any complaints are received from the private sector. EFIC is not aware of any such complaints since the last review of EFIC in 2006 and understands there is no record of complaints to the Australian Government Competitive Neutrality Complaints Office.[15]

EFIC also assesses the market gap on a portfolio basis. For each transaction EFIC applies a risk score (EFIC Risk Score (ERS)) which captures the mix of risks for each transaction, including various country and industry risks. On a portfolio basis, EFIC aims for a weighted average risk rating in the range of 3.5 to 4.5 ERS.[16] Operating in this band gives EFIC an indication of whether EFIC is operating outside the market gap. If the weighted average ERS grade of EFIC's portfolio falls below

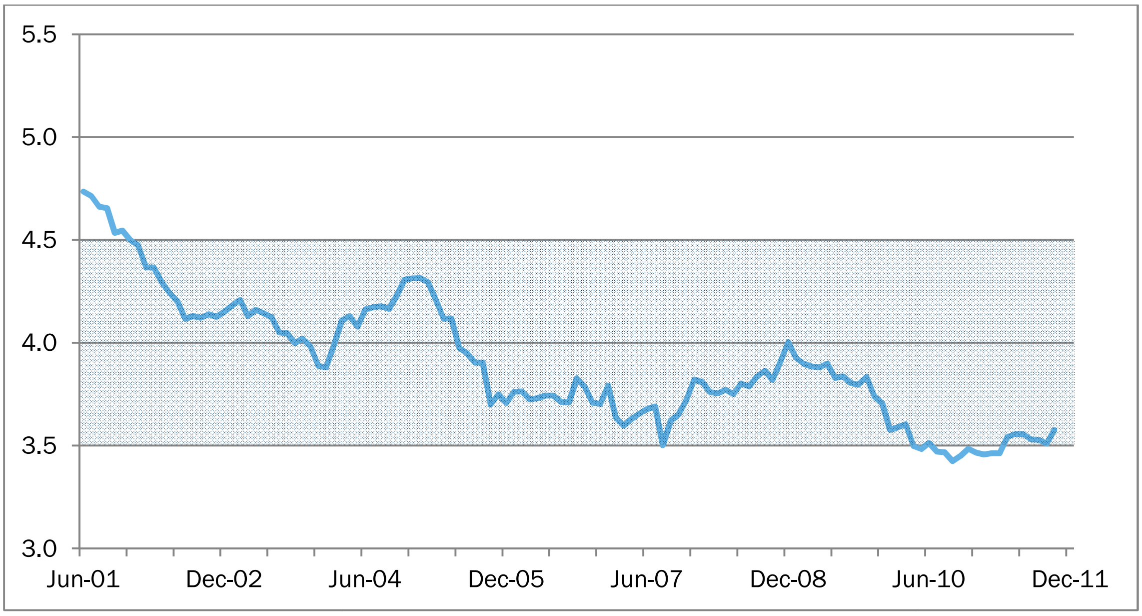
---

[15] See http://www.pc.gov.au/agcnco

[16] Where 1 is the best rated credit and 9 is a credit loss. A rating of 3.5 equates to S&P BBB- and 4.5 equates to S&P BB-.

3.5, EFIC may be straying into less risky markets where private sector financial services could be available and conversely where score exceeds 4.5, EFIC's portfolio may be assuming too much risk.

Figure 8: EFIC Weighted Average Risk Rating 2001-2011



The role of pricing:

The pricing of EFIC support is closely associated with the market gap mandate of not competing with the private market. EFIC prices its products having regard to the price set by the commercial market for a particular or a comparable risk. In doing so EFIC aims 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.

When EFIC is co-financing or providing a guarantee pricing is provided at or above market rates. When the private market is not directly involved benchmarks are used to determine appropriate pricing. This includes private sector pricing, (for example in a syndicated loan, market data with respect to the borrower, borrowers issuance in capital markets, or market pricing for comparable borrowers), and, where applicable, OECD premium pricing benchmarks are used. Please see further detail regarding pricing in response to Q35 below.

5. To what extent is the market gap evidence of market failure?

The market gap recognises instances of market failure as detailed above, but the market gap concept is broader. It encompasses a range of conditions where markets may not in an economic sense be failing, but a temporary issue, such as a lack of capacity, means that profitable projects are denied finance, or 'good' borrowers are turned away due to their size and relative difficulty in servicing. Financing exports can be complex, highly structured and involve multiple risks, as a result there are a number of considerations to be taken into account when assessing whether a transaction is in the market gap.

In addition, Australia is and always has been a net importer of capital. This reflects a surfeit of lucrative investment opportunities relative to savings capacity. In 'normal' times where there are solvent and liquid banking systems around the world and manageable private and public debt burdens, private banking and capital markets channel the capital Australia needs to fill its savings-investment gap. But in the wake of the GFC times are no longer normal. Many North Atlantic banks and most recently European banks in particular, are struggling to channel the foreign capital Australian investment projects need. Many emerging market banks although probably more solvent and liquid; do not yet have the history and accumulated skill and experience for the technicalities of doing cross-border project finance and syndicated lending.

Accordingly many prospective Australian investments with positive expected NPVs report that they have difficulty raising debt funding. Australia is thus presented with a choice: to either postpone the investments that cannot raise sufficient funding, an outcome that would slow the rate of wealth accumulation; or, through organisations such as EFIC, channel offshore funding to worthwhile projects, and thereby sustain national wealth accumulation.

6. What are the arguments for anchoring credit and insurance support to changes in global supply and demand for export finance and insurance products? Are those arguments unique to the export sector?

It is not clear what is meant by 'anchor'. EFIC's business is 'anchored', or in other words heavily influenced by, changes in global supply and demand for export finance and insurance products. If by 'anchored' there is a suggestion that EFIC be directed to operate only when credit markets are severely impaired or in crisis, this would be a mistake. In times of crisis this is when EFIC can make the largest contribution. But as discussed above market failures and imperfections are prevalent in the credit and insurance markets even in more normal times. More importantly, crises are difficult to predict and an effective crisis response capability cannot be created quickly. EFIC can only respond effectively during a crisis or crunch if it has maintained capabilities during more normal times.[17]

As described above there are a number of factors which result in market failures in export credit markets. These failures can apply in particular ways, or even more strongly to exporting firms than to non-exporting ones.

7. What is the current private sector capacity to provide export finance and insurance products offered by EFIC? How has this capacity developed in the past five years?

There are no formal measures of private sector capacity to provide export finance and insurance products. However, anecdotally, a number of observations can be made about current private sector capacity and its development over the past five years:

- Credit for SMEs has remained tight since the GFC.
- Currently, there is an undersupply of bonding facilities to well-rated corporates, due to bank de-leveraging and static or reduced bank limits combined with greater demand for bonding facilities to tender for large resource projects in Australia.
- There is a lack of capacity in the private market for domestic export infrastructure projects, which has encouraged overseas ECA support to cover the extremely large debt requirements.
- Private banking sector appetite for tenor has decreased markedly since the onset of the GFC.

[17] An analogy may be drawn here with a country's maintenance of an army in times of peace.

- Private sector insurers' credit appetite for longer tenors has developed, from a maximum of three years, five years ago out to five-seven years now. Longer tenors than seven years are still the domain of ECAs.

8. *Are there any comparable government provided credit and finance providers for non-exporters in Australia?*

EFIC is not aware of any other government organisation that provides finance and insurance for non-exporters.

Internationally there are examples of domestic focused SME banks for example (in Canada and the US), and development banks.[18]

A Clean Energy Finance Corporation (CEFC) will be established as part of the Government's Clean Energy Future package.[19] The design of the CEFC is yet to be determined; however, it seems the CEFC will be designed to encourage private investment and help overcome capital market barriers for clean energy technologies.

9. *What would be the extent and nature of under provision by the private sector if EFIC withdrew from the market? What would be the costs of this for exporters?*

In 2010-11 EFIC provided over 100 facilities worth A$593.1 million to Australian exporters and overseas investors. There is no evidence that EFIC's withdrawal would result in the private market filling this market gap. Indeed the majority of new enquiries EFIC receives are referrals from the private market, in particular banks. The private sector is unwilling to cover some risks and tenors and accordingly the exports and investments supported by EFIC would be lost. The lost exports from EFIC withdrawing from the market would exceed the amount of EFIC's direct financial support, because of its ability to 'crowd in' other finance and insurance providers to provide support. Furthermore, the impact would be greater in times of impaired credit markets, such as the current one, than in more normal times.

In addition, as discussed in Q3, EFIC represents an investment in 'soft infrastructure' built up over 50-plus years. The exact value of this soft infrastructure is difficult to determine, however it is critical, particularly in times of crisis, to assist in maintaining the flow of credit to exporters, and to provide Government with valuable information on market dynamics and developments.

Questions taken together

10. *Are some products more/less likely to be underprovided by the private sector? Are any of EFIC's products unavailable from the private sector at any price?*

11. *Are some products underprovided to particular types of exports or a particular category of exporter? Why is this the case?*

Within the bounds of the Export Finance and Insurance Corporation Act 1991 (Cth) (EFIC Act), EFIC has a broad complement of products and services that is comparable to that provided by the private

---

[18] Examples of SME banks: Business Development Bank of Canada - www.bdc.ca, Small Business Administration (SBA) US - www.export.gov. See Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) for list of development banks (EFIC is still listed as a member. EFIC has ceased its engagement with ADFIAP). http://www.adfiap.org/

[19] http://www.cleanenergyfuture.gov.au/clean-energy-future/renewable-energy/

sector. EFIC does not price its products to take market share. If a product can be provided by the private market to support an exporter then EFIC will not offer support.

In general, larger companies have greater ability to access financial products, due to their greater sophistication as well as enhanced service and specialised staff provided by banks and insurers. SMEs tend to have greater difficulty in accessing finance. SME finance issues are covered in further detail in Q17 below.

The following products are currently underprovided by the private market:

- Performance bonds are undersupplied by international and domestic banks, particularly in the engineering and resource development sectors. EFIC along with overseas ECAs are helping to bridge this financing gap.
- Project financing for large export infrastructure projects due to the extremely large debt requirements and the current withdrawal of international banks, particularly European banks. The provision of support for smaller project finance transactions is also limited where the relatively small size but complex nature of the transaction makes them less attractive to the private market.
- SME finance, in particular bonding facilities and working capital guarantees are underprovided due to structural issues in SME finance (refer to Q17 below for further detail). EFIC has reintroduced its export working capital guarantee (EWCG) to help meet this need. This product enables EFIC to 'crowd-in' private market banks to provide finance with an EFIC guarantee. EFIC has signed agreements with ANZ, Westpac, CBA and HSBC to provide the EWCG.[20]
- Foreign exchange guarantees; foreign exchange risk management is a high priority for exporters in light of Australian dollar volatility. EFIC has introduced a Foreign Exchange Facility Guarantee (FXFG) provided through Travelex and HiFX to assist exporters to hedge their foreign exchange commitments.[21]
- Film and television finance; producers struggle to get finance for their films, due to the mostly small size and complexity of finance required. EFIC has introduced the producer offset loan provided in collaboration with Screen Australia to help finance Australian film and television productions.[22]
- Commodity receivables and letters of credit; banks have reached internal bank, country and counterparty limits for commodity receivables and letters of credit. EFIC provides support to domestic and international banks based in Australia. EFIC participates in these transactions only if the bank (EFIC's client) has demonstrated to EFIC that it is not able to further sell down the counterparty risk in the commercial market.[23]

12. Does the presence of EFIC crowd out potential private sector operators?

EFIC is unaware of any complaints that it is displacing private sector operators. In fact the opposite is true; many private sector operators have asked EFIC to do more. A large proportion of EFIC support crowds in private sector participants by the nature of the product offering.

[20] http://www.efic.gov.au/finance/Workingcapitalguarantees/Pages/Exportworkingcapitalguarantee.aspx#content
[21] http://www.efic.gov.au/finance/Pages/Foreignexchangefacilityguarantee.aspx#content
[22] http://www.efic.gov.au/finance/Pages/Produceroffsetloan.aspx
[23] http://www.efic.gov.au/insurance/Pages/documentarycreditguarantee.aspx?source=finance#content

Case study 1 – Ferra Engineering

In 2010, EFIC provided support to Ferra Engineering as it bid for a sub-contract to supply parts for an international defence program (F-35 joint strike fighter program). The production-to-payment cycle was several months, which meant that the company faced a working capital shortage and needed additional funding to perform the subcontract. However, its bank was not willing to extend further credit because it had reached its lending ceiling against available security. EFIC's EWCG enabled Ferra's bank to provide additional funding for the working capital needed, thereby enabling Ferra to take on the contract. By demonstrating its ability to supply components in the early stages of the JSF program, Ferra stands to become a preferred supplier. The potential additional export income for Australia amounts to several hundreds of millions of dollars over the next 25 years.

Market Gap: market and policy failures in private markets

13. What would be an efficient response to problems in the tax system? If so, what arrangements should apply to domestic operations and importers?

EFIC has no comment on policy matters relating to the tax system.

14. What are the regulatory impediments to private provision of export finance and insurance products?

While EFIC has no comment on policy matters relating to the regulation of private providers of export finance and insurance products, it notes that ECAs are concerned that current Basel III proposals do not reflect common commercial arrangements in international trade, in particular:

- The new rules do not reflect the collateral value and risk mitigation provided by government-backed ECAs, that is, in determining the non-risk based leverage ratio, the risk weighting applied to ECA-guaranteed loans has gone from 0% to 100%.
- In determining the net stable funding ratio commercial banks are required to set aside additional capital for long-dated maturities which would discourage banks participating in ECA-guaranteed medium and long term export credits.

15. In addition to the potential impediments identified in this paper, are there any other barriers to private sector involvement in the relevant markets? What is the most appropriate way of resolving those impediments?

In noting regulatory and tax issues, incomplete and asymmetric information and imperfect competition, the Issues Paper highlights most of the issues that can result in reduced appetite from private sector insurance and finance providers to support Australian exporters and offshore direct investors.

The impact of market failures and imperfections has been discussed in detail at Q3, as well as the unique features of ECAs that can assist in resolving those impediments.

EFIC also carries out an educative role, based on its experience of over 50 years in export credit markets; this can assist in building capacity within the private market to resolve the market impediments discussed previously. However, there will remain risks which the private market is not willing to accept, which an ECA can.

16. What are the information problems affecting private providers of finance and insurance and how significant are they? What advantages does EFIC have over the private sector in resolving those information problems?

As discussed above, EFIC has the same information available to it as the private sector. In addition it has access to diplomatic and other government information and can utilise the significant information resources available through its membership of the Berne Union and participation in the OECD forum relating to export credits. OECD export credit agencies, for instance, collectively run a country risk assessment model. EFIC also invests heavily, in country risk assessment. This risk assessment covers a wide span of markets; not just 'emerging' markets, as that term is understood by portfolio investors; but 'frontier' markets as well. EFIC can sometimes convey that information to the public through its reports; at other times, it can signal that information through its cover policies, or directly through support for a project.

17. Are there any impediments that restrict exporters' access to private financial and insurance products?

Numerous studies have suggested that a shortage of access to working capital to finance exports is one of the most significant barriers for SMEs in particular.[24]

EFIC recently commissioned East & Partners, a financial sector research firm, to conduct a study into the trade finance market in Australia. The study attempted to gain a clearer picture as to the nature and importance of various impediments to accessing finance for exporters. East & Partners conducted a round of discussions with senior trade bankers enquiring into their impressions of key barriers faced by exporters when accessing finance. The individual comments were not for attribution; however East & Partners have summarised and ranked their insights.

Discounting the issue of the current strength of the Australian dollar, which limits demand for export finance generally and negatively effects exporter confidence, the key impediments to accessing export finance are:

- Complex credit process: Assessing the credit risk of an export transaction requires a significantly greater effort, involving analysis of country risk, client quality and deal risk assessment, than a 'vanilla' domestic finance application. The time and high-quality resourcing required may not offer a sufficient return on effort, particularly for smaller exporters.
- Internal Channel Attention: With all major banks relying upon a "business banker" relationship management model, competing for the 'mind-space' of this distribution channel is a key issue. Incentive structures, training and internal processes all encourage a business banker to prioritise simple, high-volume transactions such as a secured loan over a more complex export finance transaction.
- Customer Understanding: Customers may be unprepared for the additional complexity and time required for an export financing solution. Credit applications may be lodged late and with insufficient detail on the additional risks involved in an export transaction leaving little option but to default to standard financing products.

[24] See OECD (2009), "Top Barriers and Drivers to SME Internationalisation", Report by the OECD Working Party on SMEs and Entrepreneurship, OECD http://www.oecd.org/dataoecd/16/26/43357832.pdf

- Counterparty Risk: Particularly in the current global climate of economic uncertainty, the payment risk associated with the export counterparty is a substantial factor limiting banks willingness to lend in support of export transactions.

18. Is there any evidence of the exercise of market power in financial and insurance markets?

EFIC is not aware of any instances of the exercise of market power in financial and insurance markets.

EFIC encourages Australian banks to develop their presence and capabilities in supporting exporters; this is one of EFIC's mandated functions (section 7(1)(b) of the EFIC Act). There is currently one domestic bank to have a dedicated team that works with ECAs to finance medium to long term transactions, whilst other banks are currently seeking to develop stronger capabilities to support exporters.

National Interest Account

19. What are the main rationales for assisting export projects through the National Interest Account? Should these rationales be formalised in legislation or supporting documentation?

The determination of whether a project is supported on the NIA is made by Cabinet. The 'national interest' is considered by Ministers in Cabinet following a thorough inter-departmental assessment process. The nature of NIA transactions varies considerably and accordingly, the rationales for supporting transactions on the NIA will vary for each transaction.

Generally the criteria for national interest has not been formalised in legislation. For instance, Treasury makes decisions under the Foreign Acquisitions and Takeovers Act 1975 with reference to the national interest and this test does not appear to be formalised. The point is perhaps best illustrated by the former DFAT Secretary, Ashton Calvert, in 2003 noting in an address to the Lowy Institute that: "The national interest is not static, nor can it be defined in a mechanical way."[25]

20. How have past investments performed against their explicit or implicit objectives? What is the evidence that these investments have generated net benefits to the Australian community?

EFIC refers transactions to Government for consideration on the NIA. In making a referral EFIC does not make recommendations as to why provision of support would be in the national interest, nor does it detail benefits to the Australian community. National interest and 'net benefit' considerations are deliberated in Cabinet and for this reason EFIC does not have information regarding performance against explicit or implicit national interest objectives. From a purely transactional performance perspective, in the last decade, there have been 72 facilities written on the NIA worth a total of A$566 million.[26] It should be noted that the NIA has been used very infrequently in recent years with only three transactions placed on the NIA since 2008. In the last

---

[25] Address to the Low Insittute by Ashton Calver, formed Secretary of the Department of Foreign Affairs and Trade, Canberra, 26 November 2003, 'The Elvolving International Environment and Australia's National Interest': http://www.dfat.gov.au/media/speeches/department/031126_lowy_institute.html

[26] The majority of facilities were written under the now discontinued 'Unsecured Performance Bond facility' and original EWCG facilities approved by Government for the NIA.

decade these transactions have earned total premium of A$15.3 million which is paid directly to Government and over this time there has been only one write-off of A$367,000.

Questions taken together

21. What are the risks of having a National Interest Account? Are these risks justified?
22. What is the quality of the risk assessment associated with each National Interest Account proposal?
23. How are the risks ameliorated?

NIA transactions are subject to the same risk assessment processes within EFIC as other transactions.

NIA transactions have generally fallen into two broad categories: approvals on an individual basis (for example EFIC support for the PNG LNG project) or those subject to a program approach (for example, EFIC 'safety net' facilities to accept Indonesian and South Korean bank risk during the Asian crisis in 1997-1998).

In the case of individual facilities, EFIC will provide an assessment of the transaction to the Minister for Trade, including an assessment of the major credit risks, the repayment sources and terms of the transaction structure. This assessment is the outcome of EFIC's analysis of various risk areas pertaining to the transaction, including: country risks, industry risks, technical, environmental and social risks, competitive risks, management quality, and financial analysis.

In the case of program approvals on the NIA, EFIC will provide the Minister with advice detailing the proposed parameters of the program, the criteria for eligible exporters to access the program and a risk assessment of the program. As noted above, in referring a transaction or program for consideration in the national interest, EFIC makes no recommendation to the Minister. EFIC provides an assessment of the risk. It is for the Minister to make the judgement as to whether those risks are offset by national interest benefits to Australia. EFIC may be asked to provide additional assistance or advice as requested.

Risk to the Government may be ameliorated by EFIC nominating that it will take part of the liability on its Commercial Account (CA). This was the case with the PNG LNG transaction, where EFIC took US$100 million of exposure on its CA and a further US$250 million was undertaken on the NIA.

EFIC manages a NIA transaction over its life in the same manner as if the transaction was on the CA. EFIC may, in consultation with Government, seek to reduce risks associated with these transactions wherever possible. For instance, if reinsurance became available during the life of a NIA transaction, EFIC would seek to reduce risk associated with the exposure through this risk transfer mechanism

Environmental and social risks for a NIA transaction are assessed and ameliorated in the same way as those for a commercial account transaction. That is, EFIC's *Policy for environmental and social review of transactions* applies equally to both NIA and CA transactions.

Case study 2 – PNG LNG Environmental and Social Risk Assessment

For EFIC, the PNG LNG transaction was a large transaction. Assessment of environmental and social risks for this transaction was undertaken over more than a year and involved the following:

- review of the extensive environmental and social impact assessment and management documentation prepared for the project;
- in cooperation with other ECAs, preparing a terms of reference for an external, independent environmental and social consultant (IESC) and subsequently selecting the adviser based on tenders received in response to the terms of reference;
- site visits to the locations of the various components of the project;
- extensive discussions with the environmental and social staff of the project;
- extensive discussions with the team of the IESC;
- consideration of external stakeholder views of the project's environmental and social impacts;
- review and commenting on drafts of the IESC's report to the lenders;
- extensive discussions with environmental and social staff from other ECAs potentially involved in the transaction;
- discussions and negotiations with the lenders' legal advisers regarding environmental and social requirements to be included in the financing's legal agreements.

Monitoring since the project commenced has included:

- receipt and review of the IESC's monitoring reports (which are made public);
- where necessary, directing the IESC to examine specific issues as part of their monitoring;
- receipt and review of the project's quarterly environmental and social reports (which are made public);
- where necessary, requesting information from the project on specific issues;
- discussing issues with environmental and social staff from other ECAs involved in the transaction;
- consideration of external stakeholder views of the project's environmental and social impacts.

24. Are there better alternatives to a National Interest Account?

The NIA provides a flexible and important tool for Government to react to circumstances where financial support to an exporter or investor would be in the national interest. However, a major impediment to the effective use of the NIA is the uncertainty and delay inherent in the decision-making process. A prescribed decision-making process is needed, so timelines for sometimes large, complex structured transactions involving syndicates of lenders can be met within commercial timeframes.

Does EFIC distort private sector provision of export credit?

Demonstration effects from EFIC's operations:

25. What are the effects of EFIC's presence in the market on private sector entry and participation? Is there evidence of a positive demonstration effect? Is there evidence of firms being discouraged to enter, or remain in the market?

As mentioned previously in this paper, EFIC products and services complement and encourage private market support. The following examples further illustrate this:

Case study 3 – Lumwana Mine Project

In 2006, EFIC provided a loan of US$52.5 million as well as political risk insurance (PRI) cover of US$240 million to support the Lumwana mine project in Zambia owned by Equinox Minerals Limited (Equinox). EFIC's finance and insurance supported Australian content of A$70 million by underpinning the participation of Ausenco Limited for the engineering, procurement and construction contract for the project. EFIC involvement provided comfort to the private market around the contractual, country and project risks. Insurers then reinsured almost 80% of EFIC's PRI exposure. As the mine's performance was established, EFIC's facilities were entirely refinanced in March 2010 by commercial lenders on more favourable terms to the borrower. EFIC support enabled additional exports and further benefits flowed to Australia through an A$5 billion increase in shareholder value realised by the mine sponsor Equinox when it was acquired by Barrick Gold Corporation of Canada in 2011.

Case study 4 – Park Assist Pty Ltd

In 2009, EFIC supported Park Assist Pty Ltd (Park Assist) to win a US$780,000 contract with the City of Seattle to provide an electronic parking guidance system. The company needed to lodge a performance bond worth 100 per cent of the contract value. Commercial banks were unable to provide the bond, as Park Assist had been recently established, had limited tangible net worth and its assets were primarily intellectual property. EFIC's existing relationship with US bond issuer - Liberty Mutual Insurance Company, enabled Park Assist to put up the performance bond required by the contract. The company's international profile was lifted following the successful completion of this contract. Larger contracts have since been awarded and the company has since attracted credit facilities from the private market.

Is there direct competition from the private sector?

26. Is there any evidence that EFIC is directly competing with private providers in any of its products or in particular transactions?

As noted above, to EFIC's knowledge there have been no complaints that it is competing with the private sector for several years and no complaints to the competitive neutrality watchdog, the Australian Government Competitive Neutrality Complaints Office.

27. Are EFIC's processes for monitoring private sector capacity in finance and insurance markets effective? Is this process transparent to markets, customers and the Australian Government?

EFIC monitors private sector capacity on an ongoing basis primarily through:

- Bank and insurer contacts: including from both domestic (informally and also through bodies such as the Australian Trade Finance and Insurance Association (ATFIA)) and foreign sources. When considering whether an export is in the market gap EFIC may crosscheck information from other private market sources.

- Clients: EFIC receives information from clients regarding the availability of finance; information is corroborated with the private market,
- Berne Union data and reporting, as well as informal discussion amongst members,
- OECD reporting and discussion, as well as informal discussion amongst members,
- Other information sources: EFIC is a member of Asia Pacific Loan Market Association and contributes to the Project Finance committee.

EFIC makes clear to potential clients and banks and insurers that its role is not to displace the private market. EFIC's non-compete mandate and reputation as a government agency encourages other market players to provide information to EFIC. EFIC is subject to confidentiality obligations in respect of such information.

EFIC provides clear advice to potential clients regarding its assessment of the market gap and turns down potential transactions which are not in the market gap.

EFIC provides the Board, including the Government member, with a summary of the market gap relating to all transactions presented to the Board. There is regular reporting to Government regarding EFIC's operations and support. Please see Q53 below for further details of reporting. For transactions that are not required to be presented to the Board, the market-gap analysis is presented with transactions and approved in accordance with EFIC's Board delegated credit authorities.

28. How has EFIC changed the scope of its operations over time? Are these changes aligned with changes in the market gap?

EFIC expends considerable effort and resources to align its products and delivery to changing and emerging market gaps. The market gap is dynamic and EFIC must remain alert to rapid changes in the market. Please see response to Q10-11 above for examples of changes made in response to developing or changing market gaps.

29. What is an appropriate process for verifying the absence of private sector support for individual transactions?

EFIC's process for verifying the absence of private sector support for individual transactions is based on EFIC's understanding of market capacity and risk appetite shaped by the information collected from various sources as detailed in response to Q27 above.

As agreed with Government in the context of the 2006 review, EFIC forms a view on whether there is inadequate private market support and thus a market gap for individual transactions based on six considerations:

- <u>risk</u>: for example country or project-specific risks.
- <u>size</u>: whether the project's size affects commercial market participation; it may be too small or too large relative to commercial market limits.
- <u>term</u>: a facility with a longer term will be more likely in the market gap than shorter tenors.
- <u>industry</u>: for example a developing industry or green-field development, or an industry with an inherent high risk profile, such as those involving concessions or contracts with emerging market host governments.
- <u>firm size:</u> 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.

Where EFIC considers that a particular transaction may not be within the market gap, EFIC will refer it to appropriate private sector providers.

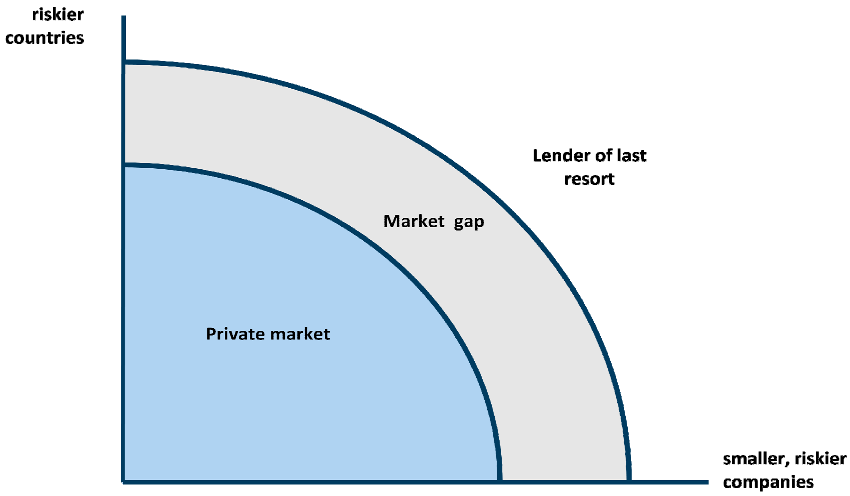
It should be noted that the absence of private sector support is not a comprehensive test for determining market gap in all cases. There may be instances where an exporter, with an established banking relationship, is unable to get the support they need as their bank lacks risk appetite for a particular transaction. For example, an exporter's relationship bank may provide support for nine of ten transactions but is unwilling to provide support for the tenth transaction to a frontier market, due to internal bank counterparty or country limits. The cost of seeking support from another bank outside an established banking relationship is prohibitive to the exporter while another bank sees little incentive to support a 'one-off' transaction with a non-relationship client. The 'switching cost' and lack of incentive for the non-relationship bank mean that the transaction is forgone. In this case a market gap remains to be filled. If EFIC considers the transaction commercially viable and provides support with appropriate risk-pricing and without complaints from the private sector, EFIC considers this support consistent with its market gap mandate. Based on EFIC's transaction history, this type of support is marginal but nonetheless facilitates profitable incremental exports for Australia.

It should be noted that requiring declarations from clients that all private financial avenues have been exhausted has significant practical implications. This would present an unreasonable administrative burden that may restrict EFIC's ability to effectively assist Australian exporters and companies investing overseas. It also has the potential to seriously impact Australian exporter competitiveness vis-a-vis foreign ECA-backed exporters.

30. Should EFIC be explicitly made a lender and insurer of last resort?

EFIC should not be a lender of last resort. EFIC provides support to exporters beyond the limit of what would be supported by the private market. However, EFIC must provide assistance profitably and can turn down requests it regards as not commercially viable which a lender of last resort is expected to support (see Figure 9 below). Arguably the role of a lender of last resort is in conflict with EFIC's mandate to support exporters in the market gap profitably and on commercial terms. It may also raise issues such as adverse selection of risks; where EFIC is expected to assume unreasonable risks. This would have consequences for profitability and could increase the likelihood of calling of the Government guarantee. Ensuring compliance with international agreements may also be a risk.

Figure 9: Market Gap vs. Lender of last resort



31. *What is the practical effect of EFIC's exemption from competitive neutrality requirements?*

Competitive neutrality policies aim to promote efficient competition between public and private businesses. Specifically, they seek to ensure that government businesses do not enjoy competitive advantages over their private sector competitors simply by virtue of their public sector ownership. The application of competitive neutrality is always subject to the proviso that the benefits outweigh the associated costs.

EFIC does not compete but complements the market and therefore at a practical level, EFIC's exemption from competitive neutrality (specifically, EFIC's exemption from income tax and a number of other taxes) does not distort the market. The exemption from taxation does not cover all taxes as EFIC does pay GST and FBT.

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. If EFIC did have a competitive advantage complaints would be expected from private banks or insurers to the effect that they have 'lost business' to EFIC.

a. Are the potential advantages offset by other requirements affecting EFIC's operation?

The market gap mandate and the policy to price in a manner comparable with other financial institutions, combine to ensure EFIC's exemption from competitive neutrality does not undermine competition in the Australian market. The potential advantages of the exemption (from the customer's perspective) are therefore offset by EFIC's operational requirements.

b. What would be the consequences for EFIC and for private sector providers if the exemption were removed?

If EFIC were to become subject to competitive neutrality requirements, it could be argued EFIC should be able to compete with the private sector. However, this would be inconsistent with EFIC's market gap mandate which restricts the type of business EFIC can do and its ability to compete.

As discussed above, EFIC does not compete with banks and insurance companies. It complements them, and its operating model is one where banks and insurance companies refer their clients to

EFIC when transactions involve risks or exposures that the banks or insurers are not comfortable with, but where EFIC may provide support and assistance.

If EFIC were to be subjected to a competitive neutrality regime there could be several complications, in particular in relation to taxation (noting that EFIC does already pay GST and FBT):

- EFIC operates two accounts, the CA and the NIA. It might be expected that any taxation equivalent regime would not apply to EFIC's NIA but would apply to the CA activities. This would distort transactions written on both accounts e.g. the PNG LNG facility.
- The taxation treatment of financial instruments, borrowings, interest and foreign exchange is particularly complex, with potentially significant timing differences between tax accounts and financial accounts.
- It should be noted that, as financial institutions are taxable, they are conscious of the significant tax implications of deals which they enter into and the potential for deals to significantly alter their taxable profits. At present, EFIC is able to structure transactions without considering its own tax situation. If it were taxable and took into account its own tax situation, it would be in a different situation from other ECAs.
- There will also be effects of income tax equivalent payments on cash flow.
- There will also be effects of income tax equivalent on profits and hence the annual dividend paid to government.

c. Is it appropriate that EFIC does not pay a debt neutrality charge or make tax equivalent payments?

If there is any evidence that EFIC is competing with the private sector then consideration of a debt neutrality charge may be relevant however, as EFIC's current area of operation remains complementary and not in competition with the private market, this is not the case.

While EFIC may have a lower cost of funds than the private market, this manifests in a higher return to the shareholder. EFIC is 100% Government owned so all its profits are either paid out to the Government as dividend or retained by EFIC as capital (which in turn is Government-owned capital). This does not provide a competitive advantage over private sector operators as cost of fund savings are not passed through to clients.

Risk sharing arrangements with private providers

32. What market failures in the private financial and insurance sectors do, EFIC's risk-sharing and risk-transfer activities, seek to address? Is this approach the best way of addressing those market failures and why?

Please refer to EFIC's response to Q3 above for consideration of market failures addressed by EFIC's participation.

EFIC aims to risk share to the maximum extent possible to draw in the private market. Under the OECD Arrangement, EFIC can only provide support for up to 85%, (80% for ships) of the eligible contract value (ECV)[27] of a transaction on its own (less than 85% if the lending bank has appetite to assume a larger un-guaranteed portion). By providing a guarantee to a bank, EFIC extends the credit

[27] EFIC refers to the total content imported into the buyer's country (the Australian content plus the foreign content) as the eligible contract value, or ECV.

the bank can provide and incentivises the bank to support the additional un-guaranteed portion of the ECV, thereby extending the private market's participation in a transaction.

The OECD rules for project finance in high income countries also require that the ECA supported component of any syndicated debt does not exceed 50% of the total debt. This means that commercial banks must take risk on the project for half of the total amount of the debt, without any assistance from ECAs. Therefore when banks look at these transactions which typically, due to the sheer size of the financing need, exceed private market capacity, they must accept credit risk on the project in order to win a portion of the business which is ECA guaranteed. It is commonly referred to as the 'sweet-sour' mix (the sweet being the ECA guaranteed portion). By enabling a 'sweet and sour mix' EFIC draws in parts of the private market which would not otherwise have participated in a transaction, enlarging the overall private market participation in transactions deemed to be otherwise in the market gap.

Through risk transfer activities, EFIC is able to crowd-in additional private market capacity, particularly from the insurance market, which would otherwise have no avenue to participate in EFIC's (or typical ECA) transactions. For example, EFIC was successful in raising private market appetite to offer medium-to-long term comprehensive cover (covering both political and commercial risks) for non-payment by a sovereign obligor. It purchased its first insurance policy from Zurich in 2001. Private market insurers were initially hesitant offering such cover because of the uncertainty surrounding subrogation rights of recovery through the Paris Club. 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.

ECAs were the dominant political risk insurers prior to the late 1990s. EFIC actively crowded-in private market insurers by selling down exposures after commencement of the insured project, completing its first risk transfer transaction in February 1999 (US$94 million for a mining project in Argentina) and a subsequent transfer of US$167 million later the same year (for another mining project in PNG). As private insurers gradually gained experience in providing this specialist insurance, insurance capacity correspondingly grew. Now political risk insurance represents a small and infrequent portion of EFIC's business.

Due in part to EFIC's active risk transfer activities with Zurich Emerging Markets Solutions (based in Washington D.C.), Zurich established an international political risk and trade credit underwriting unit in Sydney in 2006. Zurich remains as one of EFIC's active risk sharing partners.

Impacts on incentives for exporters to access private sector providers

33. Does the market gap mandate mean exporters only access EFIC products and services when there is no privately provided alternative?

EFIC provides support where the private market is unable or unwilling to do so; this refers to both capacity and, or issues of perceived risk for example:

- in some markets such as those in post-conflict states such as Sri Lanka or Iraq there is little or no risk appetite from private market participants without ECA support;
- capacity constraints may arise where banks have reached internal counterparty limits for foreign banks and without ECA support cannot participate in a transaction.

In addition please see response to Q29.

Effects on broader consumption and production

Questions taken together

34. *Why do EFIC's pricing and service arrangements draw customers to its products and services?*
35. *Are the prices charged by EFIC appropriate for the type of product and service it provides? What is the best method of setting prices for financial products and services if there are no directly comparable market prices?*

EFIC does not compete on price; pricing is intended to encourage private market participation and is not an incentive to choose EFIC over the private sector. EFIC encourages refinancing when risk, including tenor, becomes acceptable in the private market.

Clients seek EFIC support due to a number of factors as outlined previously (see Q3). Some of these factors include:

- credit constraints of the private sector;
- ability to assist with long term financing requirements beyond capacity of the private market i.e. capital goods export transactions with tenor over 10 years;
- EFIC's due diligence processes including its ability to assess country risk and overseas buyer risk; and
- reputation and perceived financial stability; particularly with regard to claims on insurance and bonding products.

EFIC prices the provision of all financial products having regard to the price set by the commercial market for the particular or a comparable risk. The specific objectives are:

- An appropriate return is achieved for the risk profile assessed by EFIC.
- That pricing offered by EFIC is not an incentive for a borrower to seek EFIC's support in favour of a private market participant.
- The return is sufficient to attract private market risk sharing partners.

EFIC does not impose unnecessary exit barriers in its loan documentation (e.g. penalty clauses). This removes incentives for the borrower to seek alternatives to EFIC provided or supported finance should favourable market conditions exist or when the underlying transaction has been sufficiently de-risked. Examples of de-risking include (i) a project achieving completion, (ii) a project demonstrating ample capacity to service debt, and (iii) for asset finance, when debt is partially repaid.

Where available, the following benchmarks are used to determine the appropriate pricing terms for each specific transaction.

- Generally, for shorter-term SME support EFIC is a price-taker. i.e. pricing is set in accordance with pricing by the private market. For example when EFIC provides a Documentary Credit Guarantees (DCG), and Foreign Exchange Facility Guarantee (FXFG), or an EWCG.
- Where there is a direct comparison with the specific transaction, for example where banks are also providing finance to the borrower on identical terms (in a syndicated financing transaction or where a bank is co-financing with EFIC), EFIC will adopt the pricing set by the commercial market.
- Where there is available market data with respect to a borrower, for example recent transactions with commercial banks or capital markets of similar duration and amortisation

profile, EFIC uses the price for that credit as a benchmark. Some adjustment may be necessary where duration or amortisation differs from the transaction EFIC provides.
- Where a borrower has been an issuer in capital markets, the price at which those instruments trade in a secondary market (reoffer spreads) provide further data points, as it demonstrates where the private market is pricing that risk in real time.
- Where there is no comparable data for a particular borrower, market pricing for comparable borrowers (i.e. same credit rating, similar credit metrics if unrated) may be useful. Similarly, peers or industry competitors provide a useful source of risk pricing, and that data may also have to be interpolated to better match the credit profile of the particular borrower.
- OECD minimum premium benchmarks establish the minimum price for sovereign risk and for corporate risk within emerging economies[28]. Requirements for sovereign credit counterparties are observed as is required within the terms of the OECD Arrangement.
- The OECD recently introduced a new Minimum Premium Benchmark tool into the Arrangement which requires OECD ECAs to use common benchmarks similar to those described above.

EFIC does not provide subsidised finance and applies commercial principles and risk pricing. All officially supported export credits provided are consistent with the terms set out in the OECD Arrangement.

36. Is there any evidence of EFIC being guided by considerations other than risk and return in selecting which projects to support and in its pricing strategy?

EFIC cannot bias its support; for example EFIC does not seek to support particular industry sectors or export markets. Each transaction is assessed on its merits against market gap criteria.

EFIC provides financial support where a transaction meets each of the following guiding principles:
- EFIC is satisfied that it is operating within the market gap.
- EFIC is operating within its mandate and in accordance with legislative requirements and the Minister’s expectations.
- Environmental and social standards either meet or exceed Australian standards where a transaction is domiciled in Australia; or the IFC Performance Standards where the transaction is domiciled elsewhere.
- The risks assumed are consistent with the Government’s requirement that EFIC be self-sustaining, and are appropriately mitigated and rewarded.

37. Is there any evidence that EFIC’s pricing does not correspond to private sector pricing for comparable risks elsewhere in the economy?

EFIC sets its prices at or above the market price based on available knowledge at that time.

[28] Economies classified as Category 1 and 2 under the OECD Arrangement.

Is EFIC maximising the benefits to users?

38. Are there any products demanded by exporters but not provided by EFIC? Is there any evidence of other export credit agencies having a high take up of particular products not available in Australia?

EFIC has a broad product range covering both finance and insurance products. The EFIC Act, however, imposes certain limitations on EFIC's ability to provide these products. For example, EFIC's provision of a loan is confined to financing an eligible export transaction involving the export of capital goods or services.

Other ECAs are able to provide loans to support their local companies' equity investments overseas, otherwise referred to as 'untied loans' referring to financing not specifically tied to exports. This is particularly prevalent among East-Asian ECAs providing products such as overseas subsidiary loans to support the internationalisation of local exporter supply chains commensurate with changes to export models.

The EFIC Act currently limits EFIC's support for overseas investments through PRI. This can limit EFIC's ability to offer multi-country (or global) PRI investment policies which invariably include existing investments.

39. With regard to the information services provided by EFIC to the public, is the information accurate and useful? Are these products available elsewhere, including from private sector providers

EFIC makes every effort to focus its analytical resources on areas that will be useful to the public. Country risk reports strive to pinpoint and assess risks to Australian companies doing business abroad. EFIC strives to be accurate in all reports and written material provided on its website. Much of the material EFIC supplies is available elsewhere, but at considerable cost, from organisations such as Oxford Analytica, the Economist Intelligence Unit and IHS Global Insight. As discussed above, country risk assessment is an artificially scarce good. There is merit in a statutory corporation such as EFIC making such information freely available, as it does, even as it pursues cost recovery for insurance and finance products.

EFIC has also developed an online resource called *Export Finance Navigator* (Navigator) with support from Austrade, to assist exporters with information about export finance and provide links to private and public sector assistance.[29] Navigator aims to assist current and potential exporters by sourcing a wide range of information on the financing alternatives available as they seek to grow their businesses through export and offshore opportunities. It divides the exporter's journey into six stages: preparing for export, finding markets, winning contracts, financing production, getting paid and expanding overseas. An exporter can easily identify which stage they're at, and then find the available support. The website not only helps exporters to find out about the export finance tools provided in the commercial market, but also the grants and tax concessions available to exporters from federal, state and territory governments.

---

[29] Mortimer Review: http://www.dfat.gov.au/publications/mortimer_report/index.html

40. Is the volume of EFIC's operations sufficient to meet demand?

EFIC has sufficient capital to service a number of SME transactions. However, there are some important constraints on EFIC's ability to meet demand:

- 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.
- EFIC like any private market financial institution imposes country, industry and counterparty limits which are a function of EFIC's capital base and risk appetite. Accumulation of exposures to one single counterparty, country, or an industry may limit EFIC's ability to meet exporter demand.

41. Does the EFIC Act unreasonably constrain EFIC's ability to provide products and services that meet the demands of its customers, and at the lowest price?

As recommended by the 2006 Review, there are a number of improvements which could be made to reduce the process orientation of the EFIC Act and align it with 'principle based' legislation commonly adopted today. This would make EFIC more efficient and better able to cater for exporter needs in providing its products and services.

Part 4 of the EFIC Act is very prescriptive in its formulation of the range of products that can be provided by EFIC, the persons to whom those products can be provided and the criteria which must be satisfied.

The inconsistent product criteria can result in some products being less accessible than others. Consequently, some products may be more expensive than they need to be.

For example, the current section 23 of the EFIC Act provides that EFIC may lend money for the purposes of financing an "eligible export transaction". The definition of "eligible export transaction" in section 3(3) of the EFIC Act, in so far as it applies to goods, is limited to "capital goods" produced or manufactured wholly or substantially in Australia. "Capital goods" are effectively goods used to make other goods. ("Capital goods" are defined in section 3(4) to mean machinery and any goods declared by the Minister to be "capital goods".[30]

This means that 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.

The only means by which EFIC could support such exports is by providing a guarantee to a financial institution which lends money to either (a) the Australian exporter (under section 16 of the EFIC Act) or (b) the overseas buyer of the commodities (under section 17 of the EFIC Act). This is because 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

---

[30] A Ministerial declaration, issued in March 1992, provides that: "*Capital goods mean those goods including concomitant services which are customarily regarded as capital goods in international trade and are accepted as such by [EFIC]*".

also a broader eligibility criterion than the “eligible export transaction” test. Providing support to an Australian exporter by way of a loan guarantee to a bank (which lends money to the exporter or its overseas buyer) can be less efficient from the perspective of transaction costs (to the Australian exporter), complexity (in terms of documentation) and time. This may particularly be the case where EFIC is providing support to domestic infrastructure projects.

The prescriptive drafting of Part 4 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.

There are a number of ECAs that apply a national benefits test to enable them to more effectively support companies to develop global supply and distribution chains and enhance international competitiveness. Please see below response to Q46-47 for further details.

42. Are the conditions of access to each product offered by EFIC reasonable? Are the conditions of access to EFIC’s services clear, concise and applied in a consistent manner?

The conditions of access to EFIC’s products are governed by the EFIC Act, OECD Arrangement and EFIC’s own management policies, such as Australian content requirements, and its Policy and Procedure on Environmental and Social Review of transactions. EFIC makes considerable efforts to make these criteria known publicly where possible, and to guide exporters and their financiers through these requirements when accessing EFIC’s products.

Improvements could be made to the EFIC Act to address the current unclear and inconsistent EFIC Act eligibility criteria. In addition to the examples noted in the response to Q41 above, the following examples are also relevant:

- The current section 14 of the EFIC Act, which provides for EFIC to enter into export payments insurance contracts, requires the underlying act or transaction to take place in the course of, or for the purposes of, “Australian export trade”. On the other hand, section 17 of the EFIC Act, which provides for EFIC to issue guarantees in relation to loans to overseas buyers, stipulates that there must be an “export contract”. “Export contract” (defined in section 3(1) of the EFIC Act) is a narrower criterion than “Australian export trade” (defined in section 3(5) of the EFIC Act). Other provisions in Part 4 (e.g. section 18) refer to an “eligible export transaction” (defined in section 3(3) of the EFIC Act) whilst other provisions (e.g. section 19) refer to both an “export contract” and an “eligible export transaction”.

- EFIC has an express power under section 19(1)(c) of the EFIC Act to issue a bond in relation to the performance of “*a contract associated with an eligible export transaction*” (in addition to providing bonding support for “eligible export transactions”). However, section 19(1)(c) does not expressly extend to bonds relating to contracts associated with an “export contract”. As discussed above in relation to the section 23 loan power, this distinction can be relevant when EFIC is considering the provision of bonding support in connection with commodity exports (or domestic infrastructure projects supporting such exports) as the “eligible export transaction” criterion only applies to capital goods. Although section 19(1)(a) allows EFIC to provide bonding support in relation to the performance of an “export contract” as such, the position is less clear in circumstances where EFIC is being asked to provide a performance or advance payment bond in relation to a contract that is associated with an export contract. Such a distinction is artificial and unhelpful.

- In relation to EFIC's issuance of political risk insurance (PRI) under section 22 of the EFIC Act, the requisite Australian nexus *is that the insured carries on business in* Australia, not that there is Australian content or a benefit flowing back to Australia in respect of the relevant overseas project. This has restricted EFIC's ability to issue both Debt and Hedge PRI policies to financial institutions which do not carry on business in Australia but which are providing debt and/or hedging facilities to an Australian sponsored project or a project with significant Australian content (for example, where an Australian company is the EPC contractor to an overseas extractives project).

Financial services licensing implications (under the Corporations Act) may also impact the ability of EFIC to develop new products.

43. Are there unnecessary delays in processing and approvals, and duplication of information requirements that result in lost time?

Clients report they are highly satisfied with their customer service.

As noted above, delays can arise when EFIC's support is to be structured as a guarantee to a financial institution (which in turn provides a loan facility to an Australian exporter) rather than the provision of direct finance by EFIC to an Australian exporter, or borrower, because the goods to be exported are not capital goods. Additionally, there can be delays in obtaining Government approval for NIA transactions. Lastly, due to EFIC's relatively small capital base, and thus concentration risks EFIC may need to seek third party risk-participants (other ECA or private sector participants) to leverage capacity, which can take additional time.

44. Is there inconsistency in administrative interpretation of requirements for accessing EFIC's services?

EFIC is not aware of any such inconsistency in its interpretation of the requirements for accessing EFIC's products and services.

45. In what ways are EFIC's processes and service superior to those encountered when dealing with the private sector?

EFIC's services and processes are similar to a commercial bank. As discussed above, EFIC does provide services in addition to the private sector, particularly regarding provision of information. EFIC also provides tailor-made solutions to SMEs for transactions of a relatively small size. Please also refer to previous answer provided in relation to Q34.

Australian content requirements

Questions taken together

46. Is the Australian content requirement appropriate for all Australian exporters?
47. Do exporters that move away from the 'produce and ship' model of exporting (for example, by expanding supply and distribution chains overseas), make themselves ineligible for EFIC's assistance? If the requirement is to be relaxed, how would that be

achieved while still meeting the objectives of the EFIC Act? What would be the implications for the domestic industry?

Currently, EFIC generally requires an Australian content level for its export finance products of 50%, 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 of EFIC's Part 4 products and services.

This 'content test' is dated given the increased use of imports in production as a strategy by Australian firms to provide cost competitive products through global supply chains. Increasingly ECAs have moved from a 'made-in' to 'made-by' approach. ECAs such as Canada's EDC, Finland's Finnvera, Denmark's EKF, Austria's OeKB, Italy's SACE, China's Sinosure, Belgium's ONDD and most recently NZECO have introduced a eligibility criteria based on a 'benefits' test.[31]

The adoption of 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. This test acknowledges that an export dollar provides the same benefit to Australia as an investment dollar.

A 'benefits test' would also be consistent with EFIC's statutory function to 'facilitate and encourage Australian export trade' (section 7(1)(a)) and its statutory duty to improve and extend the range of its products to persons involved, directly or indirectly, in Australian export trade (section 8(2)(b)(i)).

48. How visible are the services offered by EFIC to exporters? How does this compare with awareness of services offered in the private sector? Is the public promotion of EFIC sufficient?

EFIC carries out communication programmes to inform exporters and channels to exporters of EFIC products and services and to build awareness of EFIC. Communications activities are targeted at the following channels and referral sources:

- Direct marketing campaigns to Australian businesses.
- Banks.
- Government alliance partners such as state, territory or federal Government departments. This may also include participation in trade missions with partners such as Austrade.
- Event and sponsorship activities in conjunction with trade and industry bodies including state and territory chambers of commerce (and the national body Australian Chamber of Commerce and Industry), Australian Industry Group, Australian Institute of Export and Australian Services Roundtable.
- Advertising or editorial in trade and export related publications.
- Online search.

In the first instance, EFIC encourages enquiries through its website: www.efic.gov.au. Phone enquiries can also be made directly to EFIC via an 1800 number for handling by our business development team. In early 2011, EFIC implemented an IVR (Interactive Voice Response) telephone system to track calls more effectively.

---

[31] New Zealand Government Press Release: http://www.beehive.govt.nz/release/govt-boosts-trade-finance-support-exporters

The major source of enquiries comes through commercial banks. EFIC works closely with its bank partners to ensure that trade finance, sales and credit teams as well as marketing departments are aware of how EFIC can partner with them to help their clients. EFIC business development staff also receive direct enquiries from exporters as a result of presentations, meetings and attending various events.

49. Are EFIC's governance structures adequate to effectively manage the types of risk faced by EFIC?

EFIC's results over an extended period indicate that the governance structures are adequate and effective in managing the types of risks faced by EFIC.

The EFIC Board is established by section 32 of the *EFIC Act*. Section 33 (1) of the *EFIC Act* provides that: '*It is the function of the Board to manage the affairs of EFIC*'. The Board is responsible for the overall corporate governance of EFIC, including its strategic direction, establishing goals and guidelines for management and monitoring the achievement of these goals. The Board attracts and maintains high quality Directors with an appropriate mix of expertise and experience.[32]

The EFIC Act and the *Commonwealth Authorities and Companies Act 1997* (Cth) (CAC Act) impose several obligations on the Board. The key obligations include:

- notifying the Minister within 4 months of financial year end of its recommendation in relation to payment of a dividend (section 55(1) EFIC Act);
- ensuring, according to sound commercial principles, that the capital and reserves of EFIC are adequate (section 56(1) EFIC Act);
- the appointment of a Managing Director (following consultation with the Minister) (section 71(2) EFIC Act);
- ensuring EFIC's compliance with General Policy Orders that have been notified to Directors by the Minister (sections 28 and 48A of the CAC Act);
- maintaining an Audit Committee with specified functions (section 32 CAC Act);
- agreeing terms and conditions for staff (section 90 EFIC Act).

The Board has set out the duties and responsibilities of the Board and Management in the Board Charter. The Board has one permanent Committee, the Board Audit Committee. This Committee is required by section 32 of the *CAC Act*. The Board has set out the duties and responsibilities of the Board Audit Committee in the Board Audit Committee Charter.
Risk appetite goes to the heart of how EFIC does business and is important in giving key stakeholders such as the Government, employees, regulators and customers a clear indication of how EFIC will operate from a risk taking perspective and the type of risk culture that EFIC promotes. EFIC's 'Risk Appetite Statement' sets the boundaries which are fundamental to the alignment of risk taking activities within the context of the corporate plan.

The corporate plan sets out EFIC's strategic objectives and describes how the business intends to meet its key initiatives and stakeholder expectations as well as an assessment of EFIC's financial performance and capital adequacy plans. The amount of risk that EFIC assumes over the plan period and how that relates to risk tolerances established by the Board is central to, and underpins, all aspects of the way in which it operates within its market gap mandate.

Reflecting this, the Risk Control Matrix (RCM) is reviewed on a regular basis to capture new risks or identify changes to existing risks from changes in strategic direction identified in the corporate plan.

[32] The profiles of current EFIC Board members can be found at: http://www.efic.gov.au/about/EFICBoard/Pages/EFICBoard.aspx

This interaction with strategy is central to a consistent approach to risk and strategic management across EFIC.

In order to ensure effective monitoring and governance, EFIC's risk appetite incorporates a balanced mix of both quantitative and qualitative measures. These are monitored within well established risk policies, risk tolerances and operational limits set by the Board, the *CAC Act* and the *EFIC Act* and *EFIC Regulations*.

Consistent with the principles set out by the Basel Committee on Banking Supervision, the Board periodically reviews and confirms the credit risk strategy and significant credit risk policies of EFIC. Management bears responsibility for implementing the credit risk strategy approved by the Board and for developing detailed policies and procedures for identifying, measuring, monitoring and controlling credit risk.

EFIC's significant credit policies are contained in the 'Credit Guidelines', which were first approved by the Board in March 2000 and have been confirmed annually since then. Detailed credit policies and procedures are contained in the 'Credit Manual' and various departmental policy and procedure manuals.

Although not obliged to, EFIC applies the ASX Corporate Governance Council's revised Principles on Good Corporate Governance and Best Practice Recommendations[33].

EFIC believes that it has sufficient governance and risk management structures in place to manage the types of risk faced by EFIC.

50. Is it appropriate that EFIC adopt a capital adequacy policy based on APRA guidelines for banks, in line with Basel II principles?

Under Section 56 of the EFIC Act, the Board is required "to ensure, according to sound commercial principles, that the capital and reserves of EFIC at any time are sufficient". To meet the requirements of Section 56, and in line with best practice, the Board has adopted Basel II principles for measuring capital adequacy within EFIC. This is consistent with the framework APRA have adopted that requires banks in Australia to have minimum capital requirements consistent with the Basel II framework. Accordingly, EFIC management provide an annual update to the Board in relation to EFIC's capital adequacy model.

When assessing whether EFIC has sufficient capital, the Board is required to include as capital the A$200 million of callable capital that is available from the Commonwealth in accordance with the provisions of Section 56 of the EFIC Act. Under Section 56 (2) (a) of the EFIC Act it states "the value of the capital and reserves of EFIC is to be assessed on the assumption that the whole of the amount specified in subsection 54 (8) [i.e. A$200 million] had been paid to EFIC under section 54". The Board Audit Committee reviewed this policy at its 26 May 2011 meeting and the model was approved by the full Board in June 2011.

51. What are the costs and benefits of adopting APRA guidelines?

The APRA guidelines, based on the Basel II framework, do not impose significant ongoing costs, given the infrastructure to support the calculations has already been established. The reporting is part of the regular management reporting conducted by EFIC's Finance Department. The benefits of

[33] Please refer to pages 43 to 47 of EFIC's 2011 Annual Report.

adopting APRA guidelines enable the Board to benchmark EFIC's capital adequacy ratio with other financial institutions.

EFIC currently maintains a minimum 16% ratio (compared to the minimum 8% required under Basel II) which has been deemed appropriate in the past given the greater risk concentrations in EFIC's portfolio. Since the financial crisis in 2008 however, the capital adequacy ratio for most Australian banks is approaching 12%. In part, this is due to banks preparing for Basel III which will require banks to improve the quality and quantity of capital they hold. The current minimum of 8% will increase to 10.5% with an additional overlay to include a countercyclical buffer of up to 2.5% and a capital surcharge (yet to be determined) for systemically important financial institutions.

As Basel III is rolled out it will be necessary for the EFIC Board to review the minimum capital ratio and decide whether some of the overlays suggested in Basel III are appropriate for EFIC and increase the ratio above 16%. Obviously the higher the minimum capital adequacy ratio set by the Board, the fewer additional risk weighted assets that can be added.

52. What is the evidence of EFIC's compliance with its governance structures?

See response to Q49 above which details governance structures and compliance. EFIC is subject to regular internal and external audits; and half-yearly internal compliance sign-offs.

Transparency and disclosure

53. Is the quality and amount of information provided by EFIC to the Government sufficient and timely?

EFIC provides significant amounts of information and regularly reports to a number of Australian Government stakeholders, including the Minister for Trade, the Department of Foreign Affairs and Trade, Treasury, Department of Finance and Deregulation, ANAO and other agencies. This includes:

Ministerial

The EFIC Board reports to the Minister for Trade (the Minister). Regular contact is maintained with the Minister and the Minister's Office to inform the Minister on EFIC's operations. In addition to this, EFIC formally provides information and reporting to the Minister through:

1. 'Statement of Expectations' (SOE) and 'Statement of Intent' (SOI):[34]

   EFIC is required to provide the Minister with a SOI in response to the Minister's SOE. These statements express and formalise the Minister's expectations of EFIC and the Board's intention to meet these expectations. The SOE includes the obligation to keep the Minister informed of EFIC's operations and to give such reports, documents and information about those operations as the Minister requires. In addition it sets out the following expectations of EFIC regarding provision of information:
   - to work closely with the DFAT, particularly in providing full information in relation to NIA transactions and NIA management;

[34] See EFIC website for the Statement of Expectations and Statement of Intent.

- to provide DFAT and 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;
- to respond in a timely manner to any request for assistance in formulating policy from the Minister, the Minister's Office or DFAT;
- to inform the Minister and DFAT of any approaches, whether bilaterally or multilaterally, to restructure or relieve outstanding Development Import Finance Facility (DIFF) loans;
- to inform DFAT, at a sufficiently early stage, of any project seeking EFIC's support which is linked to the commercial exploitation of uranium;
- to ensure compliance with Government and Parliamentary requirements in relation to the provision of information, noting that EFIC has an exemption from the *Freedom of Information Act 1982* in relation to documents concerning anything done by it under Parts 4 or 5 of the *Export Finance and Insurance Corporation Act 1991* (EFIC Act);
- to provide timely information on the operation of the commercial account and NIA to the Department of Finance and Deregulation (DFD) in respect of budget reporting requirements;
- to comply with EFIC's obligations under the bilateral deed between Indonesia and EFIC regarding the financial aspects of the Memorandum of Understanding between Australia, Indonesia and the Global Fund and to provide timely, clear, accurate information so that DFAT can meet its responsibility to fully brief the Government and the Paris Club on this matter.

2. EFIC Corporate Plan: EFIC sends its three-year rolling corporate plan to the Minister annually. DFAT is consulted in the preparation of the Corporate Plan.

3. Annual Report: EFIC's Annual Report is tabled in Parliament each year by the Minister. DFAT is consulted during the preparation of the Annual Report. The preparation of the Annual Report is a requirement of section 9 of the CAC Act.

4. Commonwealth Authorities and Companies Act 1997 (Cth) reporting obligations:
    - EFIC is required to notify the Minister of certain significant events such as the acquisition or disposal of interests in companies or other ventures (refer section 15 of the CAC Act).
    - The EFIC Board is also required keep the Minister informed about EFIC's operations and to provide any information regarding EFIC's operations as required by the Minister for Trade or the Finance Minister (refer section of the 16 CAC Act).
    - The EFIC Board is required to provide certain budgetary estimates to the Minister (refer section 14 of the CAC Act).
    - Although the Finance Minister has not issued a notice to EFIC requiring EFIC to give the Minister interim reports (pursuant to section 13 of the CAC Act), EFIC prepares an interim financial report and sends a copy to the Minister for information purposes.

5. EFIC Act reporting obligations:
   The majority of EFIC's regular reporting obligations are contained in the CAC Act however Part 8 of the EFIC Act (Finance) contains some reporting obligations as well such as:

- Any determination by the EFIC Board Chair regarding EFIC's callable capital under section 54(1) of the EFIC Act must be notified to the Finance Minister, the Treasurer and the Minister (refer section 54(3) of the EFIC Act).
- The EFIC Board must, within 4 months after the end of each financial year, notify the Minister in writing of its recommendation regarding the payment of a dividend to the Commonwealth (refer section 55(1) of the EFIC Act). The Minister is then required to respond to EFIC's recommendation (refer section 55(2) of the EFIC Act).
- Any determination by the EFIC Board that EFIC's capital and reserves are insufficient to meet its likely liabilities (or there are reasonable grounds for believing that that may be the case at a time in the future) must be notified to the Minister (refer section 56(4) of the EFIC Act).

<u>Departmental</u>

6. Government is represented on EFIC's Board by the Secretary of the Department of Foreign Affairs and Trade (DFAT), or his/her alternate, which is currently Deputy Secretary Bruce Gosper. Board meetings are held approximately every six weeks.

7. EFIC has a Service Level Agreement (SLA) in place with DFAT, which sets out the responsibilities of both parties in administering the NIA and details a large number of reporting obligations, including biannual reporting of exposures and risk management.

8. EFIC meets with DFAT and Central Agencies at least annually, or semi-annually to present EFIC's financial and business results.

9. As a DFAT portfolio agency EFIC regularly corresponds and provides information on its operations to the Trade and Economic Division and the Trade Finance Section of DFAT, and as requested by Central Agencies.

10. EFIC and DFAT hold a quarterly meeting to discuss current issues and assist planning.

<u>Gazettal Notice</u>

11. EFIC, pursuant to section 30 of the EFIC Act, is required to publish a notice in the Australian Government Gazette setting out certain details of transactions entered into by EFIC in accordance with an approval or direction given by the Minister Part 5 of the EFIC Act.

<u>Treasury</u>

12. EFIC provides a quarterly treasury counterparty exposure report to both DFAT and DFD. This report shows the limit on and current exposure to each counterparty. This report shows EFIC's compliance with various investment rating constraints as outlined in the CAC Act.

<u>Audit</u>

13. In accordance with the CAC Act, the Auditor General, through the Australian National Audit Office (ANAO), is EFIC's external auditor and is responsible for auditing EFIC's accounts. The ANAO has contracted Ernst & Young to carry out the external audit work on its behalf.

14. In addition, the ANAO conducts other audits which may cover EFIC. Those audit reports are tabled in Parliament.

15. EFIC has contracted Deloitte to carry out its internal audit function.

Miscellaneous reporting requirements

16. Reporting under *Freedom of Information Act 1982* (Cth) (FOI Act)

    Every quarter EFIC is required to submit an FOI "Quarterly Statistical Return" to the Attorney General's Department. EFIC also submits an FOI "Annual Statistical Return" to the Attorney General's Department. In addition EFIC provides quarterly notifications to DFAT regarding whether there have been any transfers under section 16 of the FOI Act to or from EFIC.

17. Reporting under Anti-Money Laundering and Counter Terrorism Financing Act 2006 (Cth)

    EFIC submits an annual online AML/CTF compliance report to the Australian Transactions Reports and Analysis Centre (AUSTRAC)

18. Commonwealth Fraud Control Guidelines requirements

    EFIC responds to an annual online survey conducted by the Australian Institute of Criminology. The survey responses are anonymous and aggregated across Commonwealth government agencies.

19. Copyright Agency Limited

    EFIC submits reports regarding the copying and communication of copyright material to the Copyright Agency Limited (CAL) in accordance with the Commonwealth's agreement with CAL.

20. Procurement

    EFIC publishes an Annual Procurement Plan on AusTender, administered by the Department of Finance and Deregulation.

54. Are the current disclosure requirements unreasonably onerous?

In general, the reporting obligations are appropriate. However, the reporting obligations do place competing expectations upon EFIC in terms of the need to keep client information confidential and, comply with Government measures aimed at enhancing transparency (FOI and Senate questions and hearings).

The provision of section 87 of the EFIC Act and EFIC's standing FOI exemption contained in section 7(2) and part II of Schedule 2 of the FOI Act govern how EFIC deals with confidential information provided to it. Furthermore, EFIC is generally required to give comprehensive contractual undertakings that it will keep transaction information confidential.

The Minister for Trade responds to questions asked about EFIC by Members of Parliament and has been subject to Senate Orders to produce documents provided to the Minister by EFIC. EFIC is also occasionally required to attend Senate Hearings. Such questions and orders can relate to specific transactions in which EFIC may or may not be involved.

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.

EFIC in a broader context

Government services and programs for exporters

55. How do the products and services offered by EFIC complement or overlap those provided by the Australian, State and Territory governments?

EFIC is the only provider of Government provided finance and insurance services in Australia. Accordingly there is no overlap with services provided by Australian federal, state and territory governments.

EFIC has a significant level of engagement with government departments and agencies regarding trade missions, events programs and referrals. This engagement is aimed at informing exporters and channels to exporters of EFIC products and services. It also builds awareness of EFIC and assists with a coordinated whole of government approach to assisting exporters.

EFIC's engagement with Austrade has deepened across a number of fronts including an ongoing video-conference and lead referral process with offshore posts and closer website integration. EFIC also has partnership plans in place with state government departments T&I (NSW), TIQ (Queensland) and DBI (Victoria) and works on an ad-hoc basis with other states and territory governments in support of events, including the export awards and other selected activities.

56. Are there products or services under these programs, or that are not currently available, that should be provided by EFIC?

EFIC's products work alongside services provided by other federal and state government programs.
As detailed above, EFIC monitors the services provided by other federal and state government programs, where synergies are identified EFIC are receptive to suggestions and or proposals to maximise efficient delivery of government policy.

57. Are there products and services, including the provision of publicly available information and analysis that are currently provided by EFIC but could be better provided by other agencies?

There is no other agency that combines skills and expertise required for funding, lending and overseas risk assessment. EFIC products are aligned to specific markets of structured trade finance, political risk insurance and the SME sector which require specialist skills and knowledge. EFIC possesses a further advantage in country risk assessment; including the type of information EFIC supplies to the marketplace. Other agencies may be able to provide this information, but it would be outside their area of core expertise and it would therefore come at an opportunity cost to their other activities such as monetary or fiscal policymaking.

58. *Would any changes to the products and services offered by EFIC materially affect the value to exporters and taxpayers of other government programs?*

Government providers of these programs are best placed to respond to this question. EFIC is not aware of any specific impacts of any changes suggested by EFIC in this paper affecting the value to exporters and taxpayers of other government programs.

59. *Are the activities of EFIC the most cost effective way of achieving the desired trade enhancement outcomes?*

EFIC directly targets failures in the market for exports and overseas investments. EFIC is self-sustaining, and generates profit which it returns to the Government in the form of dividends. Thus EFIC does not directly call on Australian taxpayer funds; the risks borne by EFIC represent a contingent liability for the Government.

60. *Should government products and services, including those provided by EFIC, specifically target firms seeking to export overseas? What is the evidence of a market failure for firms seeking to export? Do these market failures exist for firms seeking to expand in the Australian domestic market?*

EFIC cannot comment on Government policy. However, EFIC's mandate is clear. Market failure is evidenced by the business it concludes with companies across a broad spectrum, its interaction with banks who seek its support and the absence of complaints that EFIC is competing with the private market. EFIC expects that there are businesses that cannot access sufficient funding for their domestic business in the current credit constrained environment. However, the impact on domestic businesses may be less than for exporters, given the (domestic) nature of the risk profile of such businesses.

There may be examples of market failures or imperfections that might penalise exporting and non-exporting firms alike such as credit rationing and contractual problems. However, some of these failures and imperfections can manifest themselves in a more pronounced manner for to exporting firms. Two market failures apply particularly to exporters: externalities of financial disruption and artificially scarce information. Please see the discussion in Q3.

In addition businesses operating offshore have very different risk profiles to those operating domestically; a business successfully able to expand domestically will not necessarily be able to expand their export business in a similar fashion. For example, the market gap widens for businesses operating offshore often driven by the private market's limited knowledge of foreign markets or counterparties and this cannot necessarily be addressed by methods used by the business or their to mitigate problems relating to domestic operations.

As discussed above there are a number of factors that may result in market gaps for firms exporting:

- <u>risk</u>: for example country or project-specific risks.
- <u>size</u>: whether the project's size affects commercial market participation; it may be too small or too large relative to commercial market limits.
- <u>term</u>: a facility with a longer term will be more likely in the market gap than shorter tenors.
- <u>industry</u>: for example a developing industry or green-field development, or an industry with an inherent high risk profile, such as those involving concessions or contracts with emerging market host governments.

- <u>firm size:</u> 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.
- <u>private market capacity:</u> 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.

61. What evidence is there of market failures that are faced by SME exporters in particular? What is the case for finance and insurance assistance that applies specifically to SME exporters (as opposed to SMEs generally or all exporters irrespective of size)?

SMEs face more discrimination from credit rationing than larger firms. Please see discussion of credit rationing in Q3. SME exporters face a market imperfection not faced by domestically focussed SMEs or larger exporters. For example, an SME exporter wins a contract in a distant country, such as the Ukraine or the Dominican Republic, but the exporter's Australian banker is unwilling to do the necessary due diligence on the foreign buyers or countries in which they reside in order to give the exporter the pre-shipment or post-shipment finance it needs. Equally, no foreign bank will be willing to bank the Australian exporter because they cannot or will not carry out due diligence on that exporter in view of the (small) size of the contract. So these deals do not proceed even though they may be profitable. With EFIC's specialist skills, it can assess which of these deals are potentially profitable, and which are not.

EFIC and other export credit agencies

62. What are the benefits for EFIC of reciprocal risk participation agreements? Are there risks for EFIC associated with these agreements in the role as either a lead or follower ECA?

The key benefits to EFIC of entering into reciprocal risk participation agreements (RRPAs) with other ECAs are these agreements:

- overcome EFIC's inability to provide support because of national content constraints. i.e. EFIC may be able to underwrite the entire facility and have an ECA re-insure a portion of EFIC's exposure based on the content sourced from that ECA's county;
- leverages capacity in supporting sizeable export contracts/projects which EFIC would otherwise not be able to support given its small capital base;
- improves EFIC's portfolio spread or risk concentration concerns by risk sharing; and
- enhance knowledge transfer and relationship building between ECAs. Similar to any risk participation arrangement, the risks relating to these arrangements are counterparty risk, and documentation/operational risk (the latter particularly where EFIC is a follower ECA given that it will be relying on the Lead ECA in managing the facility).

EFIC has 12 RRPAs in place with ECAs from different parts of the world and will be signing two more with the ECAs from Korea and China. This is because of Chinese and Korean companies' interest in projects in the Australian natural resources sector. These agreements have been utilised in a number of recent transactions.

63. *Do reciprocal risk participation agreements have any implications for EFIC's mandate to operate in the market gap, or its ability to price its products and services in line with commercial principles?*

EFIC's ability to risk share with an ECA or with a commercial bank, is done in accordance with its mandate for there to be a market gap and pricing being reflective of the risk it is asked to assume and not undercutting the prevailing market rates.

64. *Is it important that the Australian Government have a mechanism to invest in projects (for example, using the NIA) with other countries through their ECAs?*

It is important to have a mechanism to provide support i.e. debt finance with other countries through their ECA's, both to support exports as well as 'have a seat at the table' in the international and multilateral trade finance architecture.

In the case of onshore export-related projects, whilst direct investment from foreign companies must be approved by the Foreign Investment Review Board, the provision of debt finance by overseas parties does not, and is not subject to such levels of regulation. Thus 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 so doing the action taken may not be in Australia's interest. While EFIC could not be expected to participate in all projects supported by foreign ECAs, consideration should be given to maintaining a mechanism such as EFIC to participate in projects in this manner.

EFIC's compliance with international obligations

65. *Is EFIC's approach to environmental and social responsibility appropriate for an agency of this type? Is there enough information available publicly to make a judgement on EFIC's environmental and social responsibility?*

EFIC's approach to environmental and social responsibility is described in three documents that are publicly available on the EFIC website. These are:

- the *Policy for environmental and social review of transactions* (Policy) which sets out the principles that EFIC applies to meet its corporate values including a commitment to uphold best-practice environmental and social standards in the transactions that EFIC supports.
- the *Procedure for environmental and social review of transactions* (Procedure) describes how EFIC implements the Policy, and
- a checklist for the environmental and social screening, classification and risk evaluation process to ensure a consistent review approach and provide an audit record.

A key international commitment that EFIC is required to have regard to under the EFIC Act includes the OECD Recommendation on common approaches on the environment and officially supported export credits (the Common Approaches). EFIC has also voluntarily adopted the Equator Principles. The Policy and Procedure were developed to satisfy the requirements of both the Common Approaches and the Equator Principles. EFIC also extends the requirements of its Policy and Procedure to cover all of its transactions. The Common Approaches and Equator Principles only cover some of the products that EFIC offers to exporters and hence EFIC goes further than required under its international commitments.

The international standards that EFIC has adopted are those used by its ECA peers in the OECD (the Common Approaches, which apply to export credits) and by its commercial banking peers for project finance (the Equator Principles). As indicated, EFIC also extends its review of environmental and social issues to all transactions, going further than most of its peers.

EFIC adopted its Policy in February 2011. The new Policy and Procedure were developed following a lengthy review period that considered:

- EFIC's practical experience of implementing its 2005 Environment Policy
- feedback from EFIC's stakeholders
- our participation in a review of the OECD Common Approaches
- our participation in a review of the IFC Performance Standards (the main benchmark for both the 2005 Environment Policy and the revised Policy)
- our participation in discussion forums with organisations that apply the OECD Common Approaches and the Equator Principles
- the evolution of EFIC's business.

An internal working group prepared a draft Policy and Procedure that were published on EFIC's website for eight weeks during which time EFIC's stakeholders were invited to comment on the draft documents. EFIC received submissions on the Policy and Procedure from three civil society organisations (CSOs) and we engaged in a period of discussion and negotiation with the CSOs prior to finalising the Policy and Procedure. Details of the submissions and EFIC's responses to the issues raised are publicly available on EFIC's website.

EFIC undertakes the following to enable the public to understand EFIC's approach to environmental and social issues and to also allow the public to examine how EFIC applies its Policy and Procedure:

- reporting through the Annual Report on EFIC's approach to Corporate Responsibility
- disclosing our potential involvement in Category A transactions (transactions associated with projects with potentially significant adverse environmental and/or social impacts) prior to making a decision on providing support to the exporter. As part of the disclosure EFIC provides access to a project sponsor's environmental and social assessment via our website. EFIC also considers any submissions received in response to the disclosure
- maintaining an archive of all category A transactions considered by EFIC on our website
- maintaining a register of transactions that EFIC has supported in the current financial year. The register is updated as soon as practicable after a transaction is signed
- in discussion with CSOs EFIC has initiated a stakeholder forum the first meeting of which was held on 23rd November 2011. Subject to the concurrence of EFIC and its stakeholders it is expected that the forum will continue with two meetings a year, and
- committing to engaging an independent environmental and social expert to audit the application of the Policy and the Procedure every two years. Audit reports are provided to EFIC's Board and to the public. The first audit will be conducted before February 2013.

EFIC also responds to parliamentary inquiries, Senates Estimates and questions on notice concerning its application of, and compliance with, its Policy and Procedure.

EFIC's compliance with the OECD Common Approaches is also monitored by peer review of the environmental practitioners of the other OECD ECAs. A requirement of the Common Approaches is that each OECD ECA is required to "*Report to the [OECD] ex post on an on-going basis or at a minimum semi-annually, in accordance with Annex III, all projects classified in Category A and Category B for which a final commitment has been issued, including the reasons for classification*".

In addition ECAs are asked to voluntarily report on experience gained in respect of exports of capital goods and services to existing operations. Both types of reports are subject to peer review and questioning at the regular meetings of the OECD environmental practitioners (which usually occur twice a year). EFIC is an active participant in the reporting and peer review process.

66. Is there any evidence to suggest EFIC is not complying with its international obligations?

EFIC is not aware of any evidence to suggest it is not complying with it international obligations. A significant part of EFIC's international obligations relate to agreements EFIC/Australia is party to on account of its membership of the OECD Participants and Export Credit Group. The key agreements are the WTO Agreement Subsidies and Countervailing Measures (ASCM), the OECD Arrangement, Council Recommendations on Bribery and Officially Supported Export Credits, Common Approaches on Environmental and Social Sustainability, and the Guiding Principles on Sustainable Lending (to Low Income countries).

With regards to the OECD Arrangement, this (non-legally binding) agreement has provisions in place that require both ex-ante and ex-post notification to the Group of the provision of export credits in line with the terms and conditions set out in the Arrangement.

The OECD Export Credit Group monitors measures taken by its members (including EFIC) to meet its commitments by undertaking surveys (e.g. on Bribery and Common Approaches on the Environment) with the outcome of such surveys made publicly available on the OECD website (www.oecd.org). Such transparent exercises serve as a means to track members' compliance with their undertakings.

67. Are the international obligations appropriate in their nature and authority to meet expectations of the standards to which EFIC should comply?

This is necessarily a policy question. EFIC meets and exceeds its international obligations. The OECD agreements (e.g. The Consensus, Common Approaches, Bribery, Environment, and Sustainable Lending) have been negotiated based on inputs from OECD member countries and consensus reached in arriving at the final form of the document. Periodic reviews are undertaken on these agreements drawing on experience by members in implementing the measures, government policy positions as well as market developments. Hence, opportunities exist for EFIC to provide input to any suggested changes to these agreements in managing its commitment to comply with these standards. Similarly with the redraft of WTO's ASCM, EFIC has had (and continues to have) the opportunity to express its input via Australia's representation at the WTO.