Review of the Export Finance and Insurance Corporation

Department of Foreign Affairs and Trade
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ABBREVIATIONS

Action Statement	*Action Statement on Bribery and Officially Supported Export Credits*
AoA	*WTO Agreement on Agriculture*
APRA	Australian Prudential Regulation Authority
Arrangement	*Arrangement on Officially Supported Export Credits*
Board	EFIC Board
CAC Act	*Commonwealth Authorities and Companies Act 1997 (Cth)*
Convention	*Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*
CRP	Corporate Responsibility Policy
DFAT	Department of Foreign Affairs and Trade
DIFF	Development Import Finance Facility
ECA	Export credit agency
ECG	OECD Working Party on Export Credits and Credit Guarantees
ECGD	Export Credit Guarantee Department
EFG	Export Finance Guarantee
EDC	Export Development Canada
EMDG	Export market development grant
EFIC	Export Finance and Insurance Corporation
EFIC Act	*Export Finance and Insurance Corporation Act 1991 (Cth)*
EFIC Act 1974	*Export Finance and Insurance Corporation Act 1974 (Cth)*
EIA	Environmental Impact Assessment
EPIC	Export Payments Insurance Corporation
Finance	Department of Finance and Administration
GATT	*General Agreement on Tariffs and Trade*
Minister	Minister for Trade
NIA	National Interest Account
OECD	Organisation for Economic Cooperation and Development
PRI	Political risk insurance
Recommendation	*Recommendation on Common Approaches on Environment and Officially Supported Export Credits*
Review	2006 EFIC Review
SCM	*WTO Agreement on Subsidies and Countervailing Measures*
SME	Small to medium-sized enterprises
WTO	World Trade Organisation

FINDINGS AND RECOMMENDATIONS

Introduction

A review of the Export Finance and Insurance Corporation (EFIC) in 2006 ('the Review') was mandated by Ministers at the time of the previous review in 2003. The terms of reference for the Review are in Annex A.

The findings and recommendations for this Review are based on submissions received from nine parties, consultations with over 100 organisations including exporters, banks, insurance companies and peak bodies (see Annex B), discussions in Europe and North America with export credit agencies (ECAs) and primary insurers, research performed by the staff of the Department of Foreign Affairs and Trade (DFAT), discussions with the Export Finance and Insurance Corporation (EFIC) and discussions at meetings of the 2006 EFIC Review Interdepartmental Committee. The IDC included the Department of Prime Minister and Cabinet (PMC), the Department of Treasury (Treasury), the Department of Finance and Administration (Finance), the Department of Industry, Tourism and Resources (DITR) and the Department of Agriculture, Fisheries and Forestry (DAFF). The IDC was chaired by DFAT.

Private market developments

1. Availability of finance and insurance for international trade, globally and in Australia, is at a high point. Strong global economic conditions have resulted in an abundance of funds available for lending and risk premiums for lending to emerging markets are at historic lows. Credit risk is also low with default levels across all credit ratings being low.

2. The divestment of EFIC's short-term credit insurance business has been successful. Discussion with exporters, banks and insurers confirm that there remains fully adequate capacity in the private market to service this sector of the market and that the market has been effectively serviced since divestment occurred. There may, however, still be a market gap for short-term credit insurance in a few most difficult markets, like Iraq.

3. The long-term trend toward greater private market capacity in the export finance and insurance market has continued since the previous review. The private market is willing to extend to longer terms and into riskier markets. This is increasingly squeezing the market gap.

4. The increased capacity has cyclical elements arising from high levels of liquidity and a benign credit environment, and structural elements arising from increasing skills in riskier insurance areas and growing private sector comfort with covering certain types of risks. There is, however, some risk of a correction in the market with consequential reductions in liquidity available and a diminished appetite for risk. A correction may occur quickly and unpredictably.

5. Despite the increased private capacity, there remains a particular section of the market still the domain of ECAs. This is in the longer term insurance markets, particularly political risk insurance. Terms in excess of ten years are generally

only serviced by ECAs. Terms from five to ten years are facilitated by the presence of an ECA in a syndicate. Private market interlocutors were virtually unanimous in their belief that this segment of the market would always require some level of ECA involvement. The private market is also unable to service certain high risk countries such as Iraq and Iran.

6. ECAs elsewhere have been seen by private banks as crucial in providing export finance guarantees (EFGs) for longer term funding in certain industries. In Australia's case, shipbuilding was a key industry requiring EFGs, primarily due to the uncertainty of the underlying asset value at the end of the loan period (which extends out past ten years). This may, however, be a diminishing share of EFIC business.

7. ECAs are also considered to play an appropriate role in increasing capacity in the bonding market. While there is capacity in the private bonding market, ECAs are often called on to supplement bonding lines for specific companies that have reached the limits of their security. Financial institutions are unwilling to provide performance bonds of particular durations (usually in excess of five years) and in some high risk countries. Nevertheless, private market insurers are also able to provide unsecured performance bonds.

8. The cyclical nature of some increased private capacity suggests that, while there will be gradual reduction of the market gap, the gap will expand and contract for periods of time in the future, increasing demand for ECA involvement at times, but not consistently or comprehensively.

Small to medium-sized exporters (SMEs)

9. SMEs are not consistently able to source sufficient working capital to enable them to develop exports. Companies with turnover from $5 million to $50 million are not well serviced by the private market, which has reservations about the durability and profitability of many SMEs. This is particularly the case with SMEs that are irregular exporters or new exporters.

10. There is interest in EFIC's new Headway facility for SMEs (see description under 'Working capital facilities' on page 48 Chapter 3). As a new product it needs to be given time to settle in before determining whether it will significantly address concerns raised regarding SME access to working capital.

11. The awareness among SMEs of EFIC is generally low. In some sections of the market there is a perception that EFIC no longer exists after the sale of its short-term business to Atradius.

12. SMEs have a limited understanding of the credit insurance industry. Some had unreasonable expectations about the risk that a private sector participant or the Australian Government should assume, and the price of that risk.

EFIC's objectives

13. EFIC's primary functions under the *EFIC Act* are to: facilitate and encourage Australian export trade by providing insurance and finance to exporters; encourage banks and other financial institutions (carrying on business in Australia) to finance or assist financing of exports; and provide information and advice regarding financing or insurance of Australian exports.

14. In performing these functions, EFIC must comply with a number of duties and Ministerial directions. Of key importance is the market gap mandate which is the rationale for EFIC's existence and is central to its role. Although it is not possible expressly to define the market gap, there are some common elements and criteria which can be applied on a case by case basis to assess whether a market gap exists. These include consideration of: risk, size, term, industry, firm size, private market capacity and private market familiarity. Ultimately, the EFIC Board is responsible, whether through a direct decision or through decision making authority delegated to the management of EFIC, for compliance with the market gap mandate.

15. The responsibility of the management and board of EFIC to operate in the market gap should be set out in the Minister's Statement of Expectations. This will provide a stronger authority for the mandate and is an opportunity to clarify Ministerial expectations. The Statement of Expectations should include a statement of principle that EFIC's pricing not undercut the pricing of the private sector when private support is present (for example when syndicating) and not undercut pricing for comparable risks when private support is absent, and, where appropriate, that EFIC charge a premium for the additional risk or quality of service it is providing. Each transaction should be assessed for conformity with the market gap mandate.

Is EFIC in the market gap?

16. EFIC's business volumes in medium to long-term business have dropped since the previous review in 2003. At present it is not clear whether this will be a consistent trend. The current high level of liquidity suggests this is partly cyclical and that some increase could be expected as financial markets tighten.

17. EFIC's business since 2003 seems consistent with its market gap mandate. EFIC's export finance business since 2002-2003 has decreased, consistent with the narrowing of the market gap from both the continued structural erosion and the current cyclical upturn in liquidity. There has been some pick-up in 2006 compared to 2004 and 2005.

Table I: EFIC's business volumes on the commercial account (CA) and National Interest Account (NIA) ($ millions)

Year	Value of Signings			Number of signings			Export contracts supported[1]		
	CA	NIA	Total	CA	NIA	Total[2]	CA	NIA	Total
2002	448	7	454	27	13	31	889	26	915
2003	417	56	473	21	13	27	1,996	134	2,101
2004	91	5	96	16	5	17	502	21	523
2005	112	4	116	11	8	15	176	39	215
2006	265	5	270	18	7	21	592	33	626

18. EFIC's largest volumes of transactions are EFGs and longer term political risk insurance (PRI) (see tables 2.1 and 2.3 on pages 30 and 37 of Chapter 2 for a description of common finance and insurance products associated with ECAs) which are consistently identified as the key area of market gap for ECAs. Over 60 per cent of EFGs are in the ship sector which is difficult for the private sector to service.

19. EFIC's scope of products is more focused on the market gap, and therefore more limited in range, compared to other ECAs. EFIC's role in direct lending has decreased. ECAs such as Denmark's Eksport Kredit Fonden offer direct interest rate support to lower borrowing costs. Some ECAs continue to offer short-term insurance. EFIC does not offer 'market window' support as do other ECAs, that is, credit and insurance on private market terms provided by government agencies in competition with commercial providers. These market windows blur the distinction between market gap activities and normal commercial activities.

20. There is no evidence available that EFIC is competing with private sector providers or expanding outside of its market gap mandate. There have been no unsolicited complaints received from banks or insurers of EFIC undercutting or competing with them. EFIC's pricing is generally considered by private market players to be at or above rates charged by private market providers when present (for example, when syndicating) or that private sector providers charge for comparable levels of risk. No interlocutors considered EFIC to be pricing too low.

21. EFIC maintains its portfolio in the riskier speculative risk rating category (Risk Rating (RR) 4 to RR4.5).

22. There is concern that EFIC could compete in the performance bond market. Performance bonds are a grey area in terms of the market gap. Since 2003, EFIC has written around $150 million in performance bonds. While a significant percentage has been for riskier developing countries, a larger proportion has been to developed economies (that is, countries with low risk ratings and highly-developed private markets).

[1] Export contracts supported refers to the total value of the export contracts supported by EFIC facilities signed during that year.
[2] Signings that were written in part on the commercial account and in part on the NIA were only counted once.

23. During consultations, several exporters said that EFIC provided a 'supplemental' capacity in the bond market. That is, while most exporters had some bonding lines with private banks, due to increasing demand for performance bonds from clients, the limits of these lines can be easily exhausted. EFIC has played a role in providing one-off transactions to extend companies' capacities to issue performance bonds for contracts overseas.

24. Nevertheless, private market insurers are also able to provide unsecured bonds to supplement existing private market capacity. While there is no strong evidence that EFIC is consistently extending beyond the market gap in the performance bond market, EFIC must ensure that it does not encroach on the capacity of private sector insurers to also play a supplemental role in the private market for bonds.

Should EFIC remain as a government-owned statutory corporation?

25. When discussing the appropriate delivery mechanism for export credits the first question that needs to be addressed is whether any government-supported official export credits are in fact necessary. The findings detailed above on developments in the private market suggest that there remains a place for officially-supported export credits. While the market gap is currently narrow, it still exists and, according to most parties consulted, is likely always to remain, particularly at the longer term end of the market.

26. There is no evidence that EFIC's abolition would result in the private market 'filling the gap.' The private sector is simply unwilling to cover some risks and tenors. A country abolishing its ECA would therefore risk disadvantaging its exporters. No country in the Organisation for Economic Cooperation and Development (OECD) is considering removing its ECA from the medium to long-term sector of the market. New Zealand, which has relatively few capital good exports, has found it necessary to maintain an agency arrangement to provide medium to long-term export credits.

27. Accepting that a government supported ECA is still required, the question is then which mechanism is most suitable for the Australian case. EFIC's position as an independent agency owned by the state is the most customary form of OECD ECAs. Like all ECAs, EFIC and its operations are reviewed regularly and the latter adjusted. The most drastic of these changes was the divestment of the short-term business in 2003. At that time, EFIC's role as an independent agency to provide medium to long-term export credits was reaffirmed.

28. There is a myriad of delivery mechanisms for the services provided by ECAs. These range from government departments such as the UK's ECGD to private insurers working on contract with the government (Coface in France; Atradius in the Netherlands). There are also numerous variations within these extremes of which the EFIC model (a fully government-owned independent corporation) is one. The EFIC model is shared by ECAs such as EDC in Canada, ONDD in Belgium, Finland's Finnerva and Korea's Export Insurance Corporation. There is variation between these agencies as to the scopes of financing, insurance and guarantee activities that they support; their objectives; the degree of risk shared

with their governments; the degree of regulation; and their administrative and oversight arrangements.

29. EFIC's position as a self-funding independent agency means that, as long as it does not make long-term losses, it is not making a direct call on the taxpayer. Nevertheless, there is an opportunity cost in the money dedicated to EFIC's capital reserves. EFIC is not required to make a rate of return on this capital, but it may be that a more commercial return or more beneficial social use could be made of these resources. A move, for example, to a private agency arrangement would alleviate the need for this capital to be tied up, as each transaction would be underwritten directly by the government (although no capital would be set aside, as it currently is, for the government to meet contingent claims). The first key step in a decision to maintain or divest EFIC would then become a cost-benefit analysis on what is the best use of the capital resources.

30. Such a decision would take into account the level of EFIC's signings and exports supported. A continuation of a low level of signings (around $100 million per annum) would make EFIC's operating profitability (separate from its profit on investments) marginal within a few years and make it difficult to justify maintaining the organisation. In this instance a move to an arrangement that did not require such a level of capital resources would need to be considered.

31. Making a confident analysis of trends in EFIC's signings is difficult. While 2004 and 2005 were the lowest signing levels in the past ten years ($91 million and $112 million respectively), the two immediately preceding years were the highest ($448 million in 2002 and $417 million in 2003). This volatility is undoubtedly a factor of the strong cyclical changes in liquidity in the financial markets during this period. It is difficult, though, to determine precisely how much of the downturn is structural and how much is cyclical. EFIC's average signings from 1997 to 2006 were $260 million. The average of the years 2002 to 2005 was around $267 million, close to the long-term average. This implies that the level of signings EFIC could expect is still in the vicinity of $250 million. This potential average level of signings will be influenced largely by structural factors. An average that falls significantly below this in the period until the next review would suggest that structural shifts had further eroded the market gap requiring EFIC's involvement.

32. The interplay of cyclical and structural influences on EFIC's signings means that currently, in the high liquidity environment, we are unable to make a judgement on whether EFIC's signing levels will be maintained at a level consistent with long-term viability. Use of the term, cyclical, for the influence of global market liquidity upon EFIC's signings is not intended to imply a particular pattern to expansions and contractions in global liquidity. The current buoyant liquidity could continue, could soften or a contraction related to unforseen events might occur over the next few years. Forecasting such a trend and its impact on EFIC's level of business on the basis of a few years of signings is an intrinsically speculative task. A clearer assessment of the trend in EFIC's long-term prospects may be possible at the next review.

33. As well as addressing the cost-benefit question, detailed knowledge of the pros and cons of other types of arrangements would also need to be understood clearly.

While other methods can be simple at a conceptual level, the detail of establishing an appropriate relationship between the government and the delivery provider, or the process of establishing the government as the primary insurer, is complex.

International agreements

34. Governments, through ECAs, have traditionally been the primary providers of finance, insurance and guarantees in support of exporters (that is, export credits). Competing government support has elsewhere created problems in a 'race to the bottom' to provide support for domestic industries, subsidisation and potential crowding out of the private market.

35. The oil crisis in the 1970s created the impetus for governments to agree to constraints on competition between ECAs via the *Arrangement on Officially Supported Export Credits* ('the *Arrangement*'), a 'gentleman's agreement' between certain OECD participants that seeks to 'provide a framework for the orderly use of officially supported export credits'. Separately, multilateral trade rounds under the *General Agreement on Tariffs and Trade* (*GATT*) since 1947 have seen the development of a framework of multilateral trade rules, including specific rules for subsidies that in 1995 were embodied in the World Trade Organisation's (WTO) *Agreement on Subsidies and Countervailing Measures* ('the *SCM*').

36. The *Arrangement* and framework of multilateral trade rules continue to evolve. The scope of the *Arrangement* now addresses broad social and environmental issues. Negotiations in the OECD are expected to reduce the areas not subject to the multi-lateral disciplines. Nevertheless, market windows, circumvention and new ECAs operating outside of the scope of the *Arrangement* pose threats to the increasing comprehensiveness of this framework. Chinese, Indian and Brazilian authorities are especially aggressive. Current WTO negotiations (the so-called Doha Round) include proposals to amend the areas of the *SCM* that relate to export credits. In July 2004, WTO members agreed to elimination of export financing of over 180 days for agricultural products.

37. Australia is generally recognised as being a small open economy. There are limited Australian Government resources with which to fund an ECA to participate in an export credit race. More importantly, subsidies are generally recognised as poor policy. In this context, multi-lateral disciplines to counter the problems of a 'race to the bottom' and subsidisation associated with the government support of export credits benefit Australia.

We recommend that:

The responsibility of the management and board of EFIC to operate in the market gap be set out in the Minister's Statement of Expectations. This will provide a stronger authority for the mandate and is an opportunity to clarify Ministerial expectations.

The Statement of Expectations should include a statement of principle that EFIC's pricing not undercut the pricing of the private sector when private support is present (for example when syndicating) and not undercut pricing for

comparable risks when private support is absent, and, where appropriate, that EFIC charge a premium for the additional risk or quality of service it is providing. Each transaction should be assessed for conformity with the market gap mandate.

While there is no strong evidence that EFIC is consistently extending beyond the market gap in the performance bond market, EFIC must ensure that it does not encroach on the capacity of private sector insurers to also play a supplemental role in the private market for bonds.

EFIC remain in its current form as a statutory corporation competing strictly and solely in the market gap.

EFIC continue to explore new products and enhancements to existing products, within the bounds of its existing mandate, particularly with respect to assistance to SMEs.

The Australian Government continue to support negotiations in the WTO and OECD to clarify and improve disciplines on export credits in the *SCM* and the *Arrangement*, as well as activities to bring non-members to the *Arrangement* into compliance with its terms.

A further review of EFIC be carried out in 2009-10. We would recommend that consideration be given to having appropriate elements of the next review carried out by an independent consultant. The next review should focus particularly on EFIC's status, its objectives, and the appropriateness of current arrangements in fulfilling those objectives. The review will need to take into account the scope, type and volume of work EFIC is undertaking, and the evolution in policies and practices of other ECAs.

A comprehensive review of alternative delivery mechanisms for ECAs be undertaken to inform the next review and ensure timely consideration of the alternative delivery mechanisms. This could be undertaken prior to, or concurrently, with the next review.

CHAPTER 1: INTRODUCTION AND OPERATING ENVIRONMENT

Introduction

This chapter outlines the international environment in which the Export Finance and Insurance Corporation (EFIC) operates. It examines the historical rationales for government involvement in the provision of export credit services, and considers the implications of this government involvement. It further traces the emergence of an international framework regulating export credit agencies and recent developments in that framework.

Export Credits and Government Support

The term 'export credit' refers broadly to lending, guarantees or insurance provided in support of an exporter. Lending, guarantees or insurance can be in a form familiar to domestic commercial enterprises, such as loans, unconditional guarantees or credit insurance. Alternatively, it can be in a form particular to international trade such as letters of credit or political risk insurance.

While the term can be used to encompass the activities of private market participants, it will be used in this report to refer to export credits provided by governments. Governments provide export credits directly through government agencies or, indirectly, by contracting private sector institutions to provide export credits on their behalf. The agency or institution providing the export credit is referred to as an 'export credit agency' or ECA for short.

Governments have had a strong historical involvement in the provision of finance and insurance to exporters. The first official export credit agency, the Export Credit Guarantee Department (ECGD), was established by the United Kingdom in 1919.[3] Within decades most European countries and the United States (US) had followed, and, after World War II, many other countries, including Asia's rising industrial powers, created ECAs. Australia established its ECA in 1956.[4]

Government involvement persists to the present day. The Berne Union, the international organisation representing ECAs, currently has 51 members,[5] the majority of which are government institutions or act as an agent for a government.

There is reason to believe that domestic financial and insurance institutions in general have been poorly equipped to deal with the additional risks and information problems associated with exporting.[6] In addition to the standard business risks associated with financing or insuring a domestic institution, such as a buyer that cannot or will not

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[3] J Ray ,*Managing Official Export Credits*, Institute for International Economics, Washington, 1995, p. ix; J Pearce, *Subsidized Export Credit*, Chatham House Papers, London, 1980, p. 1.
[4] The Export Payments Insurance Corporation has since been superseded by the Export Finance and Insurance Corporation.
[5] Berne Union, *Yearbook* Newsdesk Communication, London, 2005, p.158.
[6] Ray, op. cit. note 1, p. 8; Pearce, op. cit. note 1, pp. 3, 17.

pay or a contractual dispute, exporters face additional risks, such as fluctuations in foreign exchange rates, and political and economic events beyond the exporter's control. Further, domestic financial institutions face information problems. Domestic banks may have no knowledge of the payment history of a foreign purchaser and gathering this information for a single transaction may be costly.

Nevertheless, the private sector has had a long standing involvement in the financing and insurance of exports, and has a history of innovation to deal with the additional risks and information problem.

The private sector has evolved mechanisms to manage the information problem. For example, exporters and banks are willing to extend finance to overseas creditors who have been issued letters of credit. Letters of credit are a pledge by a foreign bank to pay the purchaser's debt. Exporters and domestic banks will be more familiar with the credit record of a larger foreign bank and are better placed to price the risk of default by this foreign intermediary. Likewise, the foreign bank issuing the letter of credit is better placed to price the fee it charges the foreign purchaser for the use of its balance sheet.

Similarly, the private sector has developed mechanisms to deal with the additional business risks. Letters of credit are a means of financing short-term payments (usually less than a year) and have a history of financing the export of commodities that dates back over two hundred years. For longer term financing that was traditionally the domain of government, the private market has developed project financing which has a history which dates back to the early 20th century, with the Panama Canal allegedly being the first project financed through such a vehicle.

Project finance is primarily used to fund the construction of utilities and infrastructure where the asset being constructed (and paid for over several years) is held by a corporate vehicle. Loans for these large scale and long-term assets are provided to the corporate vehicle. The risk to the financial institution of not being repaid depends upon the profitability of the project itself, rather than the creditworthiness of the counterparty (that was often a foreign government against whose assets private entities have no recourse). Private financial institutions are familiar with commercial operations and well placed to price the risk.

Separating the commercial risks from other government related risks has also fostered the growth of political risk insurance (PRI). PRI provides coverage for government related risks to the project, such as expropriation or war. Specialised insurance markets have developed the capacity to price the risk of these events.

It is certainly not true to say that the private sector has had no involvement in the provision of financing and insurance in support of exports. In fact, as is discussed in Chapter 2, globalisation and an increased appetite from the reinsurance market have dramatically increased the scope of private sector participation in the financing and insurance of exports. The government sector has, however, clearly dominated this market during the 20th century despite the innovation displayed by the private market.

Some argue that these initiatives have taken time to evolve and that the private market has failed, and in some areas still does fail comprehensively to provide the financing

and insurance required to facilitate international trade. In contrast, others argue that government use of export credits as a tool of industry policy precluded the possibility of the private market performing this function during the 20th century.

The original rationale for the establishment of ECGD in 1919 was to stimulate the British economy after World War I.[7] From the 1930s to the 1970s, ECAs were instrumental in funding a number of large infrastructure and development projects around the world.[8] Even today, a common theme in the governing legal instruments for ECAs is the stimulation of trade or exports.[9] The use of export credits as an instrument of industry policy is not necessarily inconsistent with the market failure rationale. Government finance or insurance, where the private market is absent, facilitates exports that would not otherwise occur. This is not to say that ECAs only operated in the absence of the private market and, for reasons that are detailed below, it may be that the presence of ECAs precluded the possibility of private market participation. Whatever the rationale, the history of government involvement has had a profound impact on the functioning of the export credit market.

Implications of Government Support

Proliferation of ECAs

Government support has lead to a proliferation of the number of ECAs. While it was the Organisation for Economic Cooperation and Development (OECD) nations that traditionally retained ECAs,[10] currently more than fifty countries provide export credit facilities for their exporters and investors.[11] This includes many non-OECD nations such as Indonesia, China, India and Brazil[12] that have traditionally been recipients of export credits. Given that the conditions offered for financing or insurance (the duration, timing of payments, interest rates, premiums and fees) can be

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[7] Pearce, op. cit. note 1, p. 1.

[8] ibid,, pp. 2-3, 13; J Wang et al., *World Economic and Financial Surveys: Officially Supported Export Credits in a Changing World*, International Monetary Fund, Washington DC, 2005, p. 1.

[9] See for example: The United States of America's *Export-Import Bank Act of 1945 s2 (12 U.S.C. 635(b)(1)(A))* refers to 'the policy of the United States to foster expansion of exports of manufactured goods, agricultural products, and other goods and services, thereby contributing to the promotion and maintenance of high levels of employment and real income, a commitment to reinvestment and job creation, and the increased development of the productive resources of the United States.'; the United Kingdom's *Export and Investment Guarantees Act 1991 (c. 67) s.1(a)* refers to '…facilitating, directly or indirectly, supplies by persons carrying on business in the United Kingdom of goods or services to persons carrying on business outside the United Kingdom.'; and Canada's *Export Development Act (R.S., 1985, c. E-20) s10(1)* refers to '… supporting and developing, directly or indirectly, Canada's export trade and Canadian capacity to engage in that trade and to respond to international business opportunities.'. The Australian *Export Finance and Insurance Corporation Act 1991 (Cth) s7(1)(a)* states that a function of the Export Finance and Insurance Corporation is to 'facilitate and encourage Australian export trade…'.

[10] Ray, op. cit. note 1, pp. ix, 6.

[11] See note 3 above.

[12] Indonesia's ECA is the PT Bank Ekspor Indonesia (Persero): see http://www.bexi.co.id/; China's ECAs are the Export-Import Bank of China (China Eximbank) and Sinosure: see http://english.eximbank.gov.cn/index.jsp and http://www.sinosure.com.cn/; India's ECAs are the Export-Import Bank of India and the Export Credit Guarantee Corporation of India (ECGC): see http://www.eximbankindia.com/ and https://www.ecgcindia.com/Portal/Welcome.aspx; and Brazil's ECA is the Seguradora Brasileira Crédito à Exportação (SBCE): see http://www.sbce.com.br/us/index.asp (all accessed 28/9/06)..

an important determinant as to which country's exporter is favoured by a purchaser,[13] the proliferation of ECAs in the early half of the twentieth century was a logical, if not predictable, outcome. Exports from countries that did not provide financing were disadvantaged competitively.

Form of government support

While the 20th century saw a proliferation in the number of ECAs, there has not emerged a 'typical model' for ECAs. ECAs are typically categorised according to three major types of model: a private company acting as agent; a government department; or state-owned independent agencies.[14]

Countries such as France, Germany and Netherlands have exclusive agency arrangements with private insurers. [15] The company provides the initial risk analysis and issues the policies. In these instances all risk is borne by the government.

The United Kingdom and Switzerland operate their ECAs as government departments. In the case of the United Kingdom's ECGD, business is overseen by the United Kingdom Treasury.[16]

In the OECD, an independent, state-owned agency is the most common form of ECA. Within this general framework, though, there is considerable variation in the type of business and relationship with the government. While EFIC, Export Development Canada (EDC)[17] and the Export Import Bank of the United States (ExIm Bank)[18] provide both insurance and lending, SACE in Italy is only an insurer[19] and the Japan Bank for International Cooperation is only a lender[20]. There is also considerable variation in how responsibility for risk is split, the degree of regulation and the administrative and oversight arrangements. For example:

- ONDD, the Belgian ECA, has ceilings on its commercial account and the Government account (equivalent to the National Interest Account (NIA) discussed in Chapter 4) set by the government. ONDD can write on its own account with no government guarantee.
- Canada's EDC has a cap on the Canadian government account.[21]
- Finland's Finnerva can be authorised by the government to insure beyond the risks it would normally accept. Finnerva has a supervisory board made up of parliamentary members, as well as a general board and an advisory board.
- The Korea Export Insurance Corporation has an annual underwriting limit imposed by the Ministry of Commerce, Industry and Economy.

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[13] Ray, op. cit. note 1, pp. 8-10; Pearce, op. cit. note 1, pp. 3, 11, 21.
[14] See discussion in J. Wang et al., op. cit. note 6, p. 10; M. Kuhn et al. (1995) *Officially Supported Export Credits: Recent Developments and Prospects*, International Monetary Fund, Washington DC, pp. 14.
[15] See discussion in J. Wang et al., ibid,; M. Kuhn et al., ibid.
[16] See discussion in J. Wang et al., ibid.; M. Kuhn et al., ibid.
[17] See http://www.edc.ca/english/whoweare.htm (28/9/06).
[18] See http://www.exim.gov/about/mission.html (28/9/06).
[19] See http://www.sace.it/eng/scegliere_sace/detail.aspx?TRS_ID=1559000&ID=2520 (28/9/06).
[20] See http://www.jbic.go.jp/english/base/profile/organize/index.php (28/9/06).
[21] See http://www.edc.ca/english/disclosure_9239.htm (28/9/06).

- Sweden's EKN has borrowing rights from the National Debt Office to finance cash deficits. There is no government requirement to make a profit, only to break-even.
- Poland's KUKE has a shareholding split between the National Treasury and Central Bank, with a small proportion of shares held by the private sector.[22]

In addition to these main types, governments can also act as a contingent reinsurer. Under this model the government could choose to underwrite certain business by one or more private agencies. This would be similar to the private agency model, only the relationship is not exclusive to a single private sector agent. The New Zealand model, whereby a government department contracts out services on a tender basis (currently services are provided by Sweden's EKN), is also sometimes suggested as being a different model, although it can be viewed also as a variation on the model of a private company acting as agent.

There is no one ideal set of arrangements for an ECA. The decision regarding the optimal delivery mechanism and the details of that mechanism depend, among other things, on the objectives and scope of the organisation, the desired cost effectiveness, the degree of accountability and transparency, as well as the government policy toward the delivery of services by government. The relationships between governments and ECAs in all these different mechanisms can be complex.

All sets of arrangements have their drawbacks. The ECGD model can be inflexible and too rule based, given the close oversight of the United Kingdom Treasury. This has been recognised by the United Kingdom Government with the recent creation of a Trading Fund to provide ECGD with greater autonomy on cover and premium policies. Discussions with ECGD acknowledged that this move was an attempt to make ECGD "more like EFIC".

The private agency arrangement can create conflicts between the company's normal business and what is passed to the government's account. There can be a tendency to make the government bear as much of the risk as possible. An exclusive agency arrangement can also be seen as favouring one company at the expense of other private providers, although this could be alleviated if the contract was tendered regularly (as with the New Zealand model).

The major difficulty with the independent state-owned agency model is the contrasting objectives that can hamstring the organisation. The organisations need to operate profitably to support exporters where the private market will not (and often with a mandate not to compete with private firms). From a public policy viewpoint, a low level of signings is not a difficulty provided exporters are being serviced adequately elsewhere. From the organisation's view, there is a desire to 'grow the book' to ensure the entity's survival. The private sector origin of most ECA staff also biases the organisation to want to 'do deals'. These incentives may conflict with a government's preference for services to be delivered by the private market where possible.

[22] See http://www.jbic.go.jp/english/base/profile/organize/index.php (28/9/06).

While there is no ideal mechanism, developments to date suggest that the government department model has largely fallen out of favour. Only two OECD countries are employing this model and ECGD has had to introduce a quasi-independent mechanism through its Trading Fund arrangement to provide greater scope to act. There is no particular trend discernible of all ECAs moving to operate as do COFACE in France or Atradius in the Netherlands, as a private agent of the government.

Competition to provide favourable terms

The proliferation of ECAs and their almost universal mandate, despite their varying forms, to support their constituency's export or trade, creates a strong incentive for ECAs to offer what are commonly referred to as 'soft' terms – export credit on less stringent terms (be they longer repayment periods, less frequent timing of payments, or lower interest rates, premiums or fees) than could be obtained from the private market.[23] There is both anecdotal and empirical evidence suggesting that ECAs competed to provide soft terms in certain industries and during certain periods of the 20th century.[24] Provision of financing and insurance services to exporters on terms that undercut the private market is offered by some observers as support for the argument (discussed above) that the dominance of the export credit market by the public sector during the 20th century is attributable to government intervention rather than market failure. In the language of economics, the government has 'crowded out' the private market.[25]

While competition is generally considered desirable in economic terms, it is not necessarily so between public institutions from different nations. Owing to their underlying government support, public financiers or insurers lack an important discipline of the private market place – corporate failure. In the context of export credit services, to the extent that government ECAs provide financing or guarantees on terms that do not reflect the likelihood and cost of default, these ECAs will run at a loss in the long-term as, inevitably, the cumulative losses on non-performing loans in the portfolio and the costs of providing financing will outweigh the subsidised revenues. Theoretically, private market financiers and insurers that did not provide loans on risk-reflective terms would cease to operate. While this overstates the strictness of the discipline of corporate failure in private markets, the threat of corporate failure and the common profit motive of maximising investor returns mitigate against private financiers and insurers providing loans and insurance on terms that are not risk reflective.

In contrast, government agencies with the privileges of government guarantees and government budgetary support (often there is also no need to provide a return on capital commensurate with market rates) can run at a loss for as long as the government is prepared to subsidise the losses. The large sums of money lent during the 1930s to 1970s that were subsequently written off during the 1980s[26] support the argument that an undisciplined market for public support was evolving.

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[23] See Pearce, op. cit. note 1, p. 17.
[24] Ray, op. cit. note 1, pp. 14, 24-7, 70-1, 74-7; Pearce, ibid, pp. 3, 6, 11, 26-7;
[25] See Pearce, ibid, p. 17.
[26] The 1980s were the busiest period of activity for the Paris Club due to the debt crisis: Jean-Claude Trichet (14 June 2006) *Speech at the 50th Anniversary of the Paris Club* available at http://www.ecb.int/press/key/date/2006/html/sp060614.en.html (28/9/06); Michel Camdessus (14 June

International Agreements

Arrangement on Officially Supported Export Credits

The *Arrangement on Officially Supported Export Credits* (the *Arrangement*) came into effect amongst participating members of the OECD in April 1978.[27] Work had been going on for over a decade in the form of an export credit group in the OECD and certain participants had agreed in other forums to restrain competition between ECAs.[28] The 1970s oil crisis proved the necessary impetus finally to reach an agreement. The level of export credits had increased dramatically as OECD governments lent the surpluses of Organisation of the Petroleum Exporting Countries (OPEC) to developing countries (including the OPEC nations) and attempted to maintain their foreign exchange reserves.[29] The resulting stagflation had also caused the rates at which some ECAs lent their funds to fall below the rate at which they could borrow – ECAs were running losses by lending at below market rates.[30] In other words, the threat of an export credit race to the bottom had become a reality.

Although the *Arrangement* has evolved since its conception, its essential objectives remain embodied in the stated purpose of the *Arrangement*:

'The main purpose of the Arrangement on Officially Supported Export Credits… is to provide a framework for the orderly use of officially supported export credits.';[31] and

'The Arrangement seeks to foster a level playing field for official support… in order to encourage competition among exporters based on quality and price of goods and services exported rather than on the most favourable officially supported financial terms and conditions.'[32]

The *Arrangement* seeks to achieve this by providing transparency[33] and setting minimum conditions for export credits[34]. The *Arrangement* is a 'gentlemen's agreement' directly between participants[35] - it is not binding and has no means of enforcement, other than the reluctance of participants to be seen to be breaking their word. Currently those participants are Australia, Canada, the European Community, Japan, Korea, New Zealand, Norway, Switzerland and the United States.[36]

The *Arrangement* specifically applies to officially (or government) supported export credits, including direct financing, interest rate support, aid financing and export

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2006) *Speech at the 50th Anniversary of the Paris Club* available at http://www.bis.org/review/r060623a.pdf (28/9/06). See also Ray, op. cit., note 1, pp. 49, 63-4, 127-9; International Financial Consulting, *Review of export credit and finance services: International developments in export credit and finance services*, 2000, pp. 2-3.

[27] OECD ,*Arrangement on Officially Supported Export Credits*, December 2005, par. 2.

[28] Ray, op. cit. note 1, pp. 45-53; Pearce, op. cit. note 1, pp. 42-453.

[29] Ray, ibid, pp. 48-9.

[30] Ray, ibid, p. 45-6.

[31] *Arrangement on Officially Supported Export Credits*, op. cit. note 25, par. 1.(a).

[32] ibid, par. 1.(b).

[33] ibid, Ch. IV.

[34] ibid, Ch. II-III.

[35] ibid, par. 2.

[36] ibid, par. 3.

insurance.[37] The *Arrangement* places constraints on these activities in the form of minimum fixed interest rates for loans,[38] minimum premiums for insurance,[39] maximum terms of repayment,[40] minimum down-payments[41]and minimum terms for project finance.[42] It also details the circumstances in which trade-related tied and partially untied aid may be given.[43]

The *Arrangement* provides detailed procedures concerning notification,[44] requests for further information[45] and the review of the *Arrangement*[46] that are directed to enhancing transparency. Transparency is particularly important because the arrangement has no binding force. Transparency exposes the practices of parties that do not want to be seen to break their word, reveals practices that although to the letter of the *Arrangement* may not match its spirit, and identifies problems with the working of the *Arrangement* so that solutions can be developed.[47]

Although the *Arrangement* does not completely eliminate the ability of ECAs to provide financing and insurance on non risk reflective terms, it stops ECAs that are party to the Arrangement from undercutting one another in attempts to offer progressively better terms to their domestic firms.

The success of the *Arrangement* should not be overstated – consensus to discipline certain politically sensitive industries has proven too difficult. There are a number of industries which, due to political sensitivities, fall outside of the purview of the main ambit of the *Arrangement*. Some of these industries, including ships, nuclear power plants and civil aircraft,[48] have specific sector understandings annexed to the *Arrangement* that provide tailored disciplines.[49] The renewable energy and water sectors have trial sector understandings.[50]

Other sectors fall outside of the purview of the *Arrangement* altogether - the *Arrangement* does not apply to exports of military equipment and agricultural products,[51] official support with repayment terms of under two years[52] or the interest rate on financing supplied at floating interest rates.[53] The exceptions for agricultural products and repayment terms under two years mean that there is no restriction upon government support in the short-term credit and insurance markets (discussed in chapter 2).

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[37] ibid, par. 5.
[38] ibid, par. 15, 19, 20-23.
[39] See ibid, par. 24-8, Annex VI.
[40] See ibid, par. 12, 14.
[41] See ibid, par. 10.
[42] See ibid, par. 7, Annex X.
[43] See ibid,, Annex IX.
[44] See ibid, par. 40-47, Annex V.
[45] ibid, par. 48-54.
[46] ibid, par. 61-66.
[47] Ray, op. cit. note 1, pp. 40.
[48] *Arrangement on Officially Supported Export Credits*, op. cit. note 25, Annexes I, II and III respectively.
[49] ibid, par. 6.
[50] ibid, Annex IV.
[51] ibid, par. 5(b).
[52] ibid, par. 5.
[53] ibid, par. 19 only disciplines fixed interest rate financing.

Since 1978, the Arrangement has continued to evolve to remedy the shortcomings of the initial document and to account for developments in the export credit market. Issues of current negotiation are discussed below under 'Recent Developments'. In particular, the exceptions to the *Arrangement* detailed above are narrowing over time.

WTO Agreement on Subsidies and Countervailing Measures (SCM)

Subsidisation is not an issue unique to export credits, rather it is one element of the broader economic and political debate about trade liberalisation – a debate in which the *General Agreement on Tariffs and Trade* (the *GATT*) and its successor the World Trade Organisation (WTO) play central roles.

WTO rules do not prevent the provision of subsidies exclusively to domestic producers. Export subsidies have, however, been forbidden under the GATT and, since 1995, the WTO *Agreement on Subsidies and Countervailing Measures* (the *SCM*) has prohibited WTO members from providing subsidies (defined for the first time as financial contributions by governments which confer a benefit) that are contingent upon export performance or the use of domestic goods over imported goods.[54] Export credits clearly have the potential to be prohibited subsidies: they are direct or potentially direct financial contributions by governments and, by their very nature are designed to support exports.[55] Items (j) and (k) of the Illustrative List of Export Subsidies in Annex 1 to the *SCM* describe conditions for determining when export credits would be considered prohibited export subsidies.

Item (j) states that export guarantee or insurance programmes provided at premiums that are '…inadequate to cover the long-term operating costs and losses of the programmes' are export subsidies. The first paragraph of Item (k) states that export credits (finance) provided at below (international capital) market rates, or the payment by governments of all or part of the costs of obtaining credits, are subsidies. Whereas the *Arrangement* uses minimum terms, the *SCM* disciplines export credits that meet its legal definition by reference to market rates. The different approach reflects the different focus of the documents: the *Arrangement* seeks the orderly use of export credits and to prevent a 'race to the bottom', while the *SCM* prohibits export subsidies on the basis of a presumption that they distort international trade.

An ECA could potentially provide export credits at below market rates, but above the minimum conditions in the *Arrangement*. Provided the minimum terms of the *SCM* are set sufficiently high, this possibility is unlikely. The second paragraph of Item (k) provides a so-called 'safe haven' for export credits that conform with the
interest rate provisions of '…an international undertaking on official export credits to which at least twelve original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members)…'. The term 'successor undertaking' implies that this safe haven evolves as the 'international undertaking' changes over time. In practice, the OECD

[54] WTO, *Agreement on Subsidies and Countervailing Measures*, 1995, Art. 1, 3.
[55] See WTO, *Canada – Measures Affecting the Export of Civilian Aircraft*, Panel Report, WT/DS70/R, 14 April 1999, par. 9.230.

Arrangement is at present the only international undertaking that fits this description.[56]

Not all practices in the *Arrangement* gain protection from the safe haven. Correspondingly, practices that are not prohibited by the *Arrangement* do not necessarily gain protection from the safe haven.[57] The safe haven only applies to direct financing (not guarantees or insurance)[58] with a term of two years or more, and at fixed interest rates,[59] and applies to such financing that is in conformity with the minimum interest rate provisions and associated provisions providing minimum terms.[60] Export credits that are not covered by the *Arrangement* (i.e. floating rate financing, financing with a term of less than two years, financing of agricultural products, financing of military equipment), insurance, and financing arrangements exempted from the *Arrangement*[61] must comply with the market rate and market disciplines provided for in items (j) and (k) of the Illustrative List of Export Subsidies.

Of course, the disciplines in the *SCM* only apply to WTO members, of which there are a much greater number than those that participate in the *Arrangement*.[62] In contrast to the *Arrangement*, the *SCM* is a binding instrument at international law and has specific dispute resolution mechanisms.[63] WTO members can take advantage of the limited safe harbour offered by the *Arrangement* without being a participant to the *Arrangement* by applying its interest rate provisions.

It is worth noting that agriculture is treated separately to the *SCM*, under the WTO *Agreement on Agriculture* (*AoA*).[64] Development of agreed disciplines for agricultural export credits, guarantees or insurance programmes under the *AoA* is currently in train as part of the so-called Doha round of negotiations.[65]

Recent Developments

WTO SCM and developing countries

As part of the Doha negotiations, Brazil has tabled proposals in the WTO Negotiating Group on Rules that seek to change the rules relating to Items (j) and (k).[66] WTO

[56] ibid, par. 5.78-9, pp. 22-3.
[57] ibid, par. 5.93, 5.113 pp. 26-7, 31.
[58] ibid, par. 5.97-98, pp. 27.
[59] ibid, par. 5.106, pp. 29.
[60] ibid, par. 5.111, 5.114, p. 31.
[61] ibid, par. 5.127, p. 35; WTO, *Canada – Export credits and loan guarantees for regional aircraft: Report of the Panel*, 2002, pp. 38-47.
[62] As at 11 December 2005, the WTO had 149 members: see http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (28/9/06).
[63] See WTO, *Agreement establishing the World Trade Organization*, 1994, Annex 2 *Dispute Settlement Understanding*; and WTO , *Agreement on Subsidies and Countervailing Measures*, 1995, Art. 4 and 7.
[64] The *AoA* prohibits export subsidies unless a WTO member had such measures during an historical base period. Those are then subject to reduction commitments: see WTO , *Agreement on Subsidies and Countervailing Measures*, 1995, Art. 3.1; and WTO, *Agreement on Agriculture*, 1995, Art. 3, 8 ,9 and 10.
[65] See generally http://www.wto.org/english/tratop_e/agric_e/agric_e.htm (29/9/06).
[66] See Brazil, *Treatment of Government Support for Export Credits and Guarantees under the Agreement on Subsidies and Countervailing Measures* TN/RL/GEN/66, 11 October 2005; and Brazil (26 April 2002) *Export Credits in the WTO* TN/RL/W/5, 11 October 2005.

members that were not participants to the *Arrangement*, and thus played no part in the evolution of the *Arrangement*, are subject to its provisions.[67] Brazil stated that this encroached upon the sovereignty of WTO members.[68] Brazil also objected to items (j) and (k) requiring export finance and insurance to cover their respective costs. For developing countries, the interest on funds borrowed, used to lend through export finance or to be set aside to cover potential insurance losses, is higher.[69] To break even, these countries must offer less favourable terms to their exporters than developed countries.[70] Brazil stated that this entrenches a bias in the *SCM* towards developed countries.[71]

However, members are not subject to the *Arrangement*. Rather, they can take advantage of it as a safe haven in limited circumstances. Further, any derogation from the requirement to break even would open the scope for governments to subsidise their export credit operations. A criterion to break-even is the most pragmatic means of mimicking the discipline of corporate failure that private market providers face.

Nevertheless, the proposal reflects a growing scrutiny of the interplay between the *Arrangement* and *SCM*. There have now been several WTO disputes which have examined Items (j) and (k) of the Illustrative List of Export Subsidies.[72] It is reasonable to expect that scrutiny of the interplay between the *Arrangement* and the *SCM* will continue with different views on whether export credit and insurance is better disciplined with minimum terms, or reference to market rates and market failure.

WTO SCM and agricultural commodities

As discussed, agricultural products and products sold on less than two-year terms are exempt from the *Arrangement*. Agriculture is commonly viewed as a sensitive sector and negotiations attempting to expand the coverage of the *Arrangement* to agricultural commodities broke down during 2000. As noted above under 'WTO Agreement on Subsidies and Countervailing Measures', export credits for agricultural products are dealt with separately to the *SCM* in the *AoA*.[73]

In November 2001, WTO members agreed to negotiations on a range of subjects including agriculture as part of the Doha round of negotiations.[74] As part of the negotiations on agriculture, WTO members agreed to disciplines on export credits, guarantees and insurance programmes for the export of agricultural commodities. In July 2004, WTO members agreed to elimination of export financing of over 180

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[67] Brazil, 11 October 2005 , ibid, par. 5-6; and Brazil, 26 April 2002, ibid, p. 2.
[68] Brazil,11 October 2005, ibid, par. 9-10.
[69] ibid, pp. 1-2.
[70] ibid, pp. 1-2.
[71] ibid, par. 11-2, 16; and Brazil, 26 April 2002, op. cit. note 64, pp. 1-2.
[72] *Canada – Aircraft; 21.5 Panel: Canada Aircraft II Panel (– Export credits and loan guarantees for regional aircraft: Report of the Panel); Brazil Aircraft; 21.5 Panel; Brazil Aircraft Appellate Body; Brazil Aircraft 21.5 Appellate Body; Brazil Aircraft 21.5 II Panel; Brazil Aircraft 21.5 II Appellate Body; Korea – Shipbuilding; US Cotton*
[73] *Agreement on Subsidies and Countervailing Measures*, op. cit. note 52, Art.5.
[74] See http://www.wto.org/english/tratop_e/dda_e/dda_e.htm for further discussion (28/9/06).

days.[75] Generally, credit and insurance for the export of agricultural commodities would not extend past 180 days due to the limited storage life of agricultural products.

While negotiation of the detail of these disciplines is ongoing, WTO members agreed at the Hong Kong Ministerial in December 2005 that all forms of agricultural export subsidies be eliminated by the end of 2013; that export credits should be self financing, reflecting market consistency; and that the period of self financing should be of a sufficiently short duration so as not to effectively circumvent real commercially-oriented discipline. Negotiations were suspended in July 2006 and it is unclear when they will recommence.[76] Once the negotiations have concluded, there will be further discipline on export credits.

OECD Arrangement and project finance

As discussed above, the private sector has developed project finance as a flexible approach to the financing of long-term capital projects. Project finance links repayments to the cash flows of a particular capital project, rather than the purchaser. This approach focuses the risk upon the particular capital project, rather than the creditworthiness of the purchaser – a risk that private financiers are better able to manage.

A key feature of project finance is the matching of repayment obligations with the cash flows expected to be generated by the project. These cash flows are unlikely to be uniform over time, and may take longer to materialise, requiring a more flexible repayment profile than the equal periodic repayments traditionally provided for by the *Arrangement*.

Since 1998, ECAs have been trialling flexible repayment terms to allow government support to match this advancement in the private sector. Less frequent, unequal and longer repayment terms were allowed in exceptional circumstances if funds were available to the borrower in an uneven timing.[77] Even more flexible terms are permitted for projects that meet the definition of project financing[78] and that have been notified to other members.[79] As of 1 July 2005, these arrangements were formally included in the *Arrangement*.

The OECD working group on export credits has been working on expanding these flexibilities, as appropriate, to the various sector understandings. The effect of these modifications to the *Arrangement* will allow ECAs to provide financing on the new terms offered by private market financiers, while maintaining disciplines upon its use. It will expand both the range of projects that ECAs will be able to support, including, possibly, projects already serviced by the private sector.

[75] July 2004 Framework, WT/L/549, 2 August 2004, Annex A, para 18.
[76] Hong Kong Ministerial Declaration, 22 December 2005, par. 6.
[77] *Arrangement on Officially Supported Export Credits*, op. cit. note 25, par. 14.
[78] Contained in Appendix 1 to Annex X of ibid,
[79] ibid, par. 7 and Annex X par. 2-3.

OECD Arrangement – floating interest rates

The *Arrangement* has special disciplines for the financing of the export of aircraft for civil purposes. [80] The original *Arrangement* exempted aircraft from its disciplines.[81] Due to the scale of manufacturing operations and its significance to the defence industry, the aircraft manufacturing industry has held particular import and sensitivity for governments, in particular the United States (due to Boeing) and the European Union (due to Airbus). It was not until 1986 that a sector understanding and the application of the *Arrangement* was resolved by the OECD.[82]

Since 2005, OECD working groups on export credits have been reviewing the *Aircraft Sector Understanding* with a view to making it more comprehensive. Brazil, whose aircraft manufacturer Embraer is the fourth largest in the world (and is not an OECD member), has joined these discussions. One aspect of the discussion is introducing new disciplines upon floating interest rates. As discussed above, floating interest rates have previously been outside the scope of the *Arrangement* which disciplines the provision of financing using fixed interest rates. While discussions are ongoing within the working group, the introduction of disciplines into the *Arrangement*, while initially only for aircraft, could reduce the scope of government export finance and insurance support not disciplined by an international, multilateral agreement.

OECD Arrangement – market windows

As noted above, the *Arrangement* applies only to official government support. Credit and insurance on commercial terms in support of exports by government agencies that are on private market terms have been argued to be exempt from the operation of the *Arrangement*. While these agencies are self-financing and raise funds in the private market, they may still enjoy benefits from being a government agency – initial funding, an implicit government guarantee or exemptions from taxation. These benefits may be passed on to borrowers through rates and premiums lower than can be provided by private market participants and containing an implicit subsidy. While discussions have been held within export credit working groups of the OECD, they broke down in 2002 and have not been revived. While the subsidisation provided by these agencies is subject to a certain amount of market discipline, market windows pose a threat to the increasingly pervasive discipline of the international, multilateral agreements.

OECD Arrangement – environmental and social obligations

In response to environmental concerns, the Working Party on Export Credits and Credit Guarantees established a voluntary environmental information exchange on larger projects in late 1999. Building on this, a series of environmental common approaches were negotiated within the OECD which culminated in the adoption of the *Recommendation on Common Approaches on Environment and Officially Supported Export Credits* (the *Recommendation*) in 2003. The common approaches were designed to promote coherence of ECA environmental and social requirements, and

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[80] ibid, Annex III.
[81] Ray, op. cit. note 1, pp. 47-8.
[82] ibid, p. 48.

prevent projects, for which support had been declined on environmental grounds by one ECA, from being supported by another ECA.[83] The environmental standards canvassed two related issues: common and binding standards for project evaluation, and transparency of environmental assessments.

The process involves the screening and classification of projects into three categories to identify those requiring an environmental review. All projects above SDR[84] 10 million, and all projects in sensitive sectors or areas are classified into three categories according to their potential adverse environmental impacts.[85] Projects with the potential to have a significant adverse environmental impact require an environmental review, including a public consultations process and possibly an Environmental Impact Assessment (EIA).[86] Environmental Reviews (and EIAs) are to be benchmarked against a number of standards - host country standards; one or more of the multilateral lending agencies' (such as the Asian Development Bank) policies, and the safeguard policies published by the World Bank.[87] If support is to be provided, members must decide whether any conditions should be imposed and put in place procedures to monitor these conditions.[88]

Transparency is provided through an exchange of policies and public disclosure of information on particular projects, including EIAs.[89]

The *Recommendation* was updated after discussion in OECD export credit working groups in 2005. Its adoption and updating reflects the increasing pressure on ECAs to be seen to lead the market in addressing social issues.

OECD Arrangement - bribery

On 21 November 1997, 29 OECD members and five non-members adopted the *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions* (the *Convention*).[90] The *Convention* requires parties to make the bribery of foreign public officials an offence under their domestic law.[91] As part of a self and mutual evaluation process co-ordinated by the OECD, parties to the

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[83] OECD, *Recommendation on Common Approaches on Environment and Officially Supported Export Credits*, 2005, par. I(ii).
[84] SDRs or Special Drawing Rights are international reserve assets created by the International Monetary Fund (IMF) in 1969. Its primary purpose is as a unit of account for IMF and other international organisations. It is a potential claim on the freely usable currencies of International Monetary Fund members and is defined in terms of a basket of major currencies used in international trade and finance. Holders of SDRs can obtain these currencies in exchange for their SDRs through the arrangement of voluntary exchanges between members or by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions. For further discussion see: http://www.imf.org/external/np/exr/facts/sdr.htm (28/9/06).
[85] *Recommendation on Common Approaches on Environment and Officially Supported Export Credits* op. cit. note 82, par. II.
[86] ibid, par. III(7)-(9).
[87] ibid, par. III(12).
[88] ibid, par. IV.
[89] ibid, par. V.
[90] See http://www.oecd.org/dataoecd/59/13/1898632.pdf (28/9/06) for a list of countries that have since ratified the convention.
[91] OECD, *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, 1997, Art. 1.

Convention have since conducted reviews of their legislation and public bodies to ensure compliance with the convention.[92] In Australia, bribery of foreign public officials according to the terms defined in the *Convention* was made an offence in the Commonwealth *Criminal Code Act 1995* in 2000.[93]

Regarding officially supported export credits, the OECD Working Group on Bribery in International Transactions considered that the appropriate forum to perform the necessary monitoring and follow-up to promote the full implementation of the *Convention* was the OECD Working Party on Export Credits and Credit Guarantees ('the ECG'). In January 1998, the working party began to exchange information on an ongoing basis through a survey on Members' procedures and practices in relation to deterring and combating bribery in transactions that benefit from official export credit support. This exchange of information led to the adoption by the ECG of the *Action Statement on Bribery and Officially Supported Export Credits* (the *Action Statement*) in December 2000. The *Action Statement* has been updated twice in 2003 and 2006. The *Action Statement* requires that ECAs obtain anti-bribery undertakings from financiers and exporters that receive government support, investigate whether a supported exporter or financier has been debarred or has been charged for a bribery related offence, and take appropriate action in the presence of credible evidence of bribery.[94]

The adoption of the *Action Statement*, its subsequent updating and the review of ECAs as part of the OECD review process for the *Convention* reflect the increasing pressure on ECAs to be seen to lead the market in addressing social issues.

OECD Arrangement – new competition

While developing countries remain the primary recipients of export credits,[95] their own ECAs have become significant providers of export credits. Brazil, China and India have ECAs that write sizeable amounts of business.[96] None of these countries is a participant to the *Arrangement*, although some claim that they follow its prescriptions. In contrast to OECD members participating in information exchanges under the *Arrangement*, information on the activities of these ECAs is limited. This lack of transparency makes the commerciality of their operations and their consistency with the terms of the *Arrangement* or the *SCM* difficult to gauge.

Conclusion

The export credit market during the 20th century was dominated by government ECAs. Government intervention carried two related risks – a 'race to the bottom' and subsidisation. A subsidy race may have been the reason for the weak presence of the private market during the 20th century and certainly imposed losses upon the taxpayers of states that created ECAs. ECAs are disciplined against these risks by the multilateral agreements that govern ECAs – the *SCM*, the *AoA* and the *Arrangement*. The scope of these instruments is becoming increasingly comprehensive, increasingly

[92] See http://www.oecd.org/document/12/0,2340,en_2649_34859_35692940_1_1_1_1,00.html.
[93] See *Criminal Code Amendment (theft, fraud, bribery and related offences) Act 2000 (Cth).*
[94] See OECD, *Action Statement on Bribery and Officially Supported Export Credits*, 2006, par. 2.
[95] Wang et al. op. cit. note 6, pp. 4, 7.
[96] ibid, pp. 8, 12.

addressing broader social and environmental issues traditionally outside their traditional ambit. Nevertheless, market windows, circumvention and new ECAs operating outside the scope of the agreements pose the most significant threat to the increasing comprehensiveness of this framework.

Australia is generally recognised as being a small, open economy. There are limited Australian Government resources with which to fund an ECA to participate in an export credit race. More importantly, subsidies are generally recognised as poor policy.

Australia should continue to support negotiations to clarify and improve disciplines on export credits in the *SCM*, *AoA* and the *Arrangement*, as well as activities to bring non-members to the *Arrangement* into compliance with its terms.

CHAPTER 2: INTERNATIONAL PRIVATE MARKET DEVELOPMENTS

Introduction

This chapter outlines trends over the last two decades in the global market in which the Export Finance and Insurance Corporation (EFIC) operates. Additionally, it details developments in that market since the last review in 2003. It details the growth of the private market towards the close of the 20th century, and the current high liquidity and benign credit risk in which private market competitors are operating. It divides the market in which EFIC operates according to the duration of support provided and the type of support (finance or insurance) and examines trends in each of those segments of the market. Additionally, it discusses developments in the supply of finance and insurance in support of bonding, a specialised market relating to the export of services.

The information contained in this chapter was mostly obtained during public consultations with various stakeholders. Observations that are not referenced in the footnotes are based upon views formed from in-confidence discussions with parties throughout the public consultations process.

Export Credits and the Private Market

While the public sector dominated the market for financing and insuring exports during the 20th century, it was superseded at the end of the 20th century by financing and insurance from private market providers.[97] Official export credits continued to grow, but are an increasingly smaller portion of overall export finance and insurance.[98] New commitments by official export credit agencies (ECAs) relative to total official and private lending plus foreign direct investment have declined from nearly 35 per cent in the early 1990s to about 20 per cent in 2000-2002.[99] Export credits supported by official ECAs in Organisation for Economic Cooperation and Development (OECD) countries relative to their exports fell from between 2 to 3 per cent in 1992 to below 1 per cent in 2002. Officially supported medium and long-term export credits in OECD countries relative to capital goods exports have declined from 7 per cent in 1992 to slightly above 2 per cent in 2002.[100]

The reason for increased private sector involvement depends upon the rationale one ascribes to the historical dominance of the public sector throughout most of the 20th century. Consolidation in the private market and the 'globalisation' of business have arguably allowed larger multinational financiers and insurers to overcome the information and risk problems associated with financing and insuring international trade discussed in the previous chapter.[101] Additionally, some commentators have asserted that private insurers gained comfort with the risks involved by observing

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[97] Wang et al. op. cit. note 6, p. 2.

[98] ibid, pp. 1,4; F Drummond, *Recent Export Credit Market Developments*, International Monetary Fund, 1997, pp. 4-5; Kuhn et al, op. cit. note 1, pp. 1, 7.

[99] Wang et al., ibid, p. 7.

[100] ibid,p. 7.

[101] ibid,pp. 10-1, 15-6; International Financial Consulting , op. cit. note 24, pp. 2-3, 8-11.

ECAs over time.[102] Alternatively, the substantial writing off of debt in the 1980s and the increasing comprehensive multilateral treaties governing export credits have arguably brought greater discipline to ECAs restricting the extent of subsidy and 'crowding out' of the private sector.[103]

Availability of finance and insurance for international trade is at a high point. The global economy has experienced a phase of strong growth, with economic growth at around three to four per cent per annum over the last three years.[104] Developing countries, the traditional destination of most ECA finance and insurance, generated an average economic growth in excess of six per cent over the same period.[105] Although there are risks, this outlook is expected to continue for the medium to long-term, particularly in the light of economic reforms in many developing countries.[106] Long-term interest rates remain low, despite tightening of monetary policy in developed countries.[107] In this environment, an abundance of funds is available for lending.[108] As a consequence of the abundance of liquidity and benign credit environment, risk premiums for emerging market lending have reached near historic lows.[109] Default levels across all credit ratings are also low.

The abundance of liquidity and benign credit environment described above is not simply the view of academic observers, but was confirmed by all financial institutions and insurers visited during public consultations. Observations about the private market discussed in this chapter should be considered in light of this global context, which is experiencing high levels of economic growth and liquidity.

Typically, the market for export credits is divided into the short-term and medium to long-term. While commentators commonly delineate the market by the duration of payment, with short-term generally referring to deferred payment terms of up to two years and medium- to long-term generally referring to repayments over two years, a clearer distinction can be made according to the nature of the good being exported.

Short-term credit and insurance is provided for the export of commodities (for example agricultural or 'soft commodities' such as wheat and rice; and mineral or 'hard commodities' such as coal and steel) and equipment such as machinery and spare parts. Deferred payment terms for these goods are generally only extended up to their short shelf or useful life (usually within a year), or the short time in which they can be on-sold into a liquid market. These goods would be expected to be sold in the purchasing country within that period and the sale of the goods makes available the funds required for deferred payment. Similarly, the relatively low value of the

[102] International Financial Consulting. ibid, p. 8.
[103] Wang et al., op. cit. note 6, pp. 14-5; International Financial Consulting, ibid, pp. 2-3, 8-11.
[104] World Bank, *Global Economic Prospects 2006* , Washington. 2006, p. 4. In contrast growth in 2001 and 2000 was 1.3 and 1.6 per cent respectively: World Bank, *Global Economic Prospects 2002*, Washington, 2002, p. 3; International Monetary Fund, *World Economic Outlook*, Washington D.C., 2006, p. 2; International Monetary Fund *World Economic Outlook*, Washington D.C., 2004, p. 3.
[105] *Global Economic Prospects 2006* , ibid, pp. 4-5; *World Economic Outlook*, 2006, ibid, p. 2; *World Economic Outlook*, 2004, pp. 3,8.
[106] *Global Economic Prospects 2006*, pp. 4, 8-10; *World Economic Outlook*, 2006, pp. 2-3,5,6-7.
[107] *Global Economic Prospects 2006*, pp. 11-2; *World Economic Outlook*, 2006, ibid, pp. 4-6, 20-1.
[108] See for example the discussion in *World Economic Outlook*., ibid, pp. 135-59.
[109] *Global economic prospects 2006*, ibid, p. 11; *World Economic Outlook*, 2006, ibid, pp. 4-6.

individual items exported should not create a cash flow burden that would require longer repayment terms.

In contrast, medium to long-term credit and insurance is provided for the export of capital products such as ships, mining equipment, processing facilities and infrastructure assets. The division between items exported in the short-term and the medium to long-term credit and insurance markets is not mutually exclusive. Some larger items of machinery are exported under medium to long-term repayment terms. The key point is that these assets are not purchased to be on-sold or consumed in production. Rather, they are expected to generate cashflows from their operation over extended periods of time. For example, a mine and processing facility could produce a hard commodity over a fifteen year life. The large sums required to purchase these assets means that payment over their extended productive lives is a common means of financing their purchase.

Short-Term Market

Table 2.1: Summary of short-term market products

Product	Description
Deferred payment	Payment after the purchaser receives the goods.
Letters of credit	Foreign bank guarantees the payment by the purchaser.
Factoring and discounting	Sale of the right to a deferred payment to a third party.
Working capital facilities	Exporters obtain general facilities from banks to extend their working capital.
Short-term credit insurance	Pays the covered party for defaults by the purchaser.
Reinsurance of short-term credit	Insurance for insurers, allowing primary insurers to share their risk with specialised reinsurance companies.
Bonding	Refers to a sum of money that is set aside (often with the purchaser) as a guarantee that specific obligations will be met (i.e. performance bond).

Deferred payment for exports

Short-term credit is most commonly provided by exporters allowing deferred payment for goods, that is, payment at a date after the purchaser receives the goods (or title to the goods). In this case, exporters carry the risk of a default in payment. For the reasons discussed above, the vast majority of short-term credit is on terms of less than a year.

Deferred payment terms are not extended for all goods. The majority of exports occur on up front cash terms. Up front payment allows exporters to meet payments to their own suppliers and manage their cashflows. In contrast, deferred payment allows purchasers to pay for products after they have been on-sold or allows purchasers to direct cash that would otherwise go to paying for the good to other purposes (such as paying their own suppliers). In this sense, deferred payment is favourable for purchasers. It extends working capital financing and is generally considered undesirable for exporters because it creates a drain on their working capital.

Whether exporters extend deferred payment to purchasers depends upon the bargaining power of the exporter and the country to which they are exporting.

Offering deferred payment can be necessary to meet terms offered by competitors. Exporters that provide niche products are often able to push back on demands by purchasers for deferred payment terms and require up front payment. In certain countries (particularly in Europe), deferred payment terms are the usual course of business.

Letters of credit

Deferred payment terms can be formalised through a letter of credit or documentary credit where a foreign bank guarantees the payment by the purchaser and is obliged to pay if the purchaser fails to do so. As discussed in Chapter 1, letters of credit overcome the information problem faced by an exporter who is unfamiliar with the credit risk of the purchaser. The foreign bank is essentially an intermediary better placed to assess and vouch for the credit risk of its domestic client (the purchaser). It also shifts the credit risk from the purchaser to the foreign bank. There are variations on the process that, for example, involve a domestic bank that has a relationship with the exporter either advising the exporter of the terms of the letter of credit (essentially conveying the letter of credit from the issuing bank to the exporter) or guaranteeing (confirming) the payment of the foreign bank that has assumed the credit risk for the purchaser.

Letters of credit have existed for at least two hundred years and are commonly available from most domestic banks in most countries or from international banks with global offices (such as Standard Chartered and HSBC). Similarly, domestic banks and international banks in most countries will advise on the terms of a letter of credit or confirm payments by foreign banks. There are also international banks that specialise in particular industries. For example, BNP Paribus and Rabobank have a focus on 'soft' commodities.

Availability of letters of credit is primarily an assessment by the banks involved of credit risk – the foreign bank issuing the letter of credit must have sufficient comfort in the creditworthiness of the purchaser, and the domestic bank advising or confirming the letter of credit, must have sufficient comfort in the creditworthiness of the foreign bank.

Banks do occasionally go 'off cover' for issuing or confirming letters of credit from certain countries, when political events make the risk of a default in repayment too high. Banks may also require credit insurance before issuing or confirming letters of credit for purchasers with a high risk of default. For example, banks will not issue or confirm letters of credit for the Government of Iraq without credit insurance.

The letter of credit process is underpinned by documentation. The exporter must present certain documents, such as a bill of lading or purchase order, to receive payment from the issuing bank. The willingness of institutions to provide letters of credit can, in addition to an assessment of credit risk, depend upon a bank's comfort with the documentation processes of the exporter. For some small exporters that have less developed documentation procedures, this can pose a problem.

Factoring and discounting

Exporters can discount or factor their foreign receivables. Both refer to the sale of the right to a deferred payment to a third party. The difference between the two is the party that bears responsibility for collection of the payment and, consequently, the risk of default. For discounting, the responsibility for collection remains with the exporter. For factoring, the legal right is assigned to the third party who manages debt collection. The exporter will only be paid a portion of the amount owed, because the third party is advancing money and assuming the risk of a default in payment.

Factoring and discounting are alternative methods of managing working capital and are substitutes for borrowing working capital (see below) to make cash payments. Selling receivables and borrowing both involve an advance from a financial institution and the payment of interest (in the case of factoring or discounting, the discount on the amount paid to the exporter is in effect an interest payment).

Factoring and discounting are a common service for domestic and international accounts and are performed by a number of banks and specialised financial institutions in developed economies. Unlike a working capital facility, a financial institution's willingness to provide factoring depends upon an assessment of the creditworthiness of the purchaser, rather than the security available from the exporter. Generally, entire 'books' of accounts are factored or discounted and an assessment is made of the creditworthiness of the overall client base in the book. Additionally, willingness to factor or discount is dependent upon the documentation procedures of the exporter. Financial institutions will be reluctant to advance money to assume debts that they are unable to collect due to inadequate or unenforceable invoicing. Factoring and discounting can be an attractive alternative to borrowing for small to medium-sized exporters (SMEs) that do not have the security or credit history to borrow.

Working capital facilities

As discussed above, extending deferred payment terms can make it difficult for exporters to match the timing of the cash receipts from export sales with cash payments to suppliers. To provide additional cash to meet these payments while awaiting cash receipts, exporters can obtain general facilities from banks to extend their working capital. Working capital and overdraft facilities are a common service in corporate and business banking, and are provided by almost all domestic and international banks.

A bank's decision to provide a working capital facility is primarily based on an assessment of the credit risk of the exporter's business as a whole (as opposed to the purchaser's credit risk in the case of letters of credit). Credit risk depends upon an assessment of the likelihood of default (in other words, the expected cashflows and risk of those cashflows) by the exporter, and the security available if there is a default. For fast growing SMEs, limited security and a short credit history can restrict access to working capital facilities.

Short-term credit insurance

A distinction is commonly made between commercial risk and political risk. Commercial risk refers to the risk of a default in payment because of a business event, such as bankruptcy. Political or country risk refers to the risk of a default in payment because of a change in a country's political structure or policies. While there is no exact definition of political risk (see further discussion below under 'Political Risk Insurance'), it is generally considered broad enough to encompass events outside of the management of the commercial entity and that are within the domain of governments. It encompasses events that are beyond the direct control of governments, such as the outbreak of war, as well as events that are a matter of government policy, such as the inability to repatriate interest payments due to foreign exchange controls.

Credit insurance pays the covered party for defaults by a purchaser. As opposed to the longer term market for political risk insurance (PRI) discussed below, credit insurance covers defaults arising from both commercial and political events. The export of commodities and equipment is generally a low value, high volume business and policies are usually provided to cover several shipments over a period of time.

Credit insurance is not a pre-requisite for international trade, but rather a means of managing risk. Demand for credit insurance is determined by exporter or financier appetite to assume credit risks. Exporters may be unfamiliar with a foreign purchaser or perceive the risk of purchasers in a particular country to be too high. Likewise, banks may not be willing to assume the political risk associated with certain countries and not extend a letter of credit without insurance.

The supply of credit insurance was the domain of ECAs for a large part of the 20th century.[110] A guarantee for documentary credits was one of the first schemes established by the Export Credit Guarantee Department (ECGD) in 1921.[111] The ECAs that emerged in other countries during the middle of the 20th century followed suit and, whether due to market failure or 'crowding out', were the primary source of credit insurance.[112] The private sector in contrast, provided credit insurance for domestic businesses – it had been doing so for at least two centuries.[113] To the extent that private banks did extend credit insurance internationally, they did so as a provider for their domestic client base and, thus, had a regional focus.[114]

This position changed during the 1990s with the emergence, through merger activity, of a handful of large international private credit insurers. The economies of scale and scope from larger operations gave these private companies a means to overcome the information problems identified in Chapter 1. The private credit insurers maintain large databases[115] of credit risks around the world creating a significant information

[110] International Financial Consulting, op. cit. note 24, p. 1.
[111] Pearce, op. cit. note 1, p. 1.
[112] International Financial Consulting op. cit. note 24, p. 1, 8.
[113] ibid, p. 1.
[114] ibid.
[115] For example, both Euler Hermes and Coface claim to have databases on over 40 million businesses worldwide: http://www.eulerhermes.com/group/en/who_we_are/index.html (28/9/06); and http://www.coface.com/CofacePortal/redirection.jsp?pageId=pages/home/wwd/i&site=COM_en_EN (28/9/06).

technology overhead that it is economical to spread over a large volume of transactions.[116] Providing credit insurance for exporters in a variety of countries (as opposed to the traditional position of only providing credit insurance for domestic clients) allows these companies to service clients across different countries with the same information. By the end of the 1990s, more than 95 per cent of short-term business from European Union economies was written by the private sector.[117]

The trend of consolidation has continued to date,[118] such that the private market for credit insurance is dominated by four insurers: Euler Hermes, Coface, Atradius and American International Group (AIG).

Table 2.2: Private market credit insurers

Insurer	Principal shareholders	Core markets	Core business lines	Countries with offices	Staff	Credit rating
Euler Hermes	AGF (69%) (Allianz owns 59% of AGF)	UK, Belgium, France	• Credit insurance • Receivables financing • Receivables management • Bonding • Credit information • Fidelity insurance	40	5,400	S&P: AA- Moodys: A1
Coface	Natexis Banques Populaires (100%)	France, Germany, Italy, US	• Credit insurance • Credit information • Receivables management • Receivables financing	58	4,600	Moodys:Aa3
Atradius	Swiss Re (35%) Deutsche Bank (34%)	Germany, Holland, Belgium, US	• Credit insurance • Receivables financing • Receivables management • Bonding • Credit information	40	3,600	S&P: A Moodys: A2
American International Group	Publicly listed on NYSE	US	Offers full array of insurance products, including trade credit	130	35,000	S&P: AA Moodys: Aa2

In turn, governments have been privatising the short-term arms of their ECAs.[119] ECGD sold its short-term business to a private insurer in 1991. The US sold parts of its short-term book in 1992, France privatised Coface in 1994, and Singapore privatised its ECA in 2003. The private sector has assumed a dominant role in this sector despite a lack of discipline on short-term operations through either the *SCM* or the *Arrangement* discussed in Chapter 1.

[116] International Financial Consulting, op. cit. note 24, p. 8.
[117] Wang et al., op. cit. note 6, p. 10; International Financial Consulting, op. cit. note 24, p. 9.
[118] Euler acquired Hermes-AG from Allianz in July 2002 - the merged entity was renamed Euler Hermes in 2003 and integration of the two groups was completed in 2004; in August 2001, Swiss Re acquired NCM and merged it with Gerling Credit Insurance Group - the merged entity was renamed Atradius on 1 January 2004; and in November 2002, CNA sold its credit insurance division to Coface.
[119] Wang et al., op. cit. note 6, p. 15.

As well as continuing to consolidate and assume the majority of risk, the scope of risk that the private market is prepared to assume has expanded. In the current benign credit environment, the private sector is willing to cover longer durations of credit risk. Anecdotally, private insurers have spoken of covering risks of up to five years.

There are still countries, however, for which private insurers do not provide cover. They do not feel that they can recoup adequate return from exporters or bankers to cover the political risk to which they are exposed. For example, post conflict countries such as Afghanistan and Iraq are countries for which the private sector will not provide credit insurance.

Reinsurance of short-term credit

Reinsurance is quaintly described as insurance for insurers. Reinsurance allows primary insurers to share their risk with specialised reinsurance companies. This allows them to balance the spread of risks in their own portfolios and frees up capital that would otherwise have to be set aside for prudential regulation purposes. Reinsurance can be taken out on a treaty or facultative basis.

Reinsurance treaties allow a primary insurer to pass on all risks that fall within the terms of the treaty. For well diversified portfolios of exposures, this reduces the cost of having to negotiate terms and fees for individual lines. Typically the fees and scope of a reinsurance treaty are renegotiated on an annual basis. The broad scope of reinsurance treaties means that reinsurers are assuming both well priced and under-priced risks. They do so under the assumption that the sum of gains and losses from this mis-pricing will net out in a well diversified portfolio of exposures. To mitigate the possibility of taking on mostly under-priced risks, reinsurers develop close relationships and, through these relationships, gauge the quality of the primary insurer's processes and underwriting philosophy. As a reinsurer gains comfort with a primary insurer over time, the scope of treaties can enlarge at annual reviews. Reinsurance on a facultative basis covers individual exposures (policies with individual companies) rather than portfolios of risk. Typically, facultative insurance is used to cover large, poorly diversified risks or to fill gaps in the scope of a reinsurance treaty. Because these exposures are poorly diversified, the risk and terms of the exposure receive greater attention. Additionally, there is a risk of 'adverse selection' – primary insurers will only pass poor risks on to reinsurers. The cost of this sort of insurance is higher due to this individual attention.

The reinsurance industry experienced significant consolidation during the last twenty years[120] with the majority of most categories of primary insurance passing to the largest five insurers.[121] The reinsurance market for credit insurance is dominated by three large reinsurers: Munich Re, Swiss Re and Hannover Re. Almost all risk carried by the big four credit insurers passes to these reinsurers under treaties. There are

[120] For example, in November 1996, Munich Re purchased American Re; in August 1996 Swiss Re acquired Mercantile and General Re; in June 1995, General Re and Cologne Re merged; in December 1998, General Re was acquired by Berkshire Hathaway; and, in November 2005, Swiss Re acquired GE Insurance Solutions from General Electric.

[121] J Cohen, 2005, *Reinsurance: Writers on the Storm: A Deeper Look at Reinsurance*, Merrill Lynch, 24 October, pp. 9-10. Note that in November 2005 Swiss Re acquired GE Insurance Solutions from General Electric.

several properties of credit insurance that make it an attractive proposition for reinsurers. The portfolios of the big four credit insurers are large and diversified geographically. The exposures are typically for durations of 180 days or fewer, and capital that must be set aside for prudential regulation purposes to meet potential losses can be rolled over several times each year to earn fees.

Despite the abundance of reinsurance available, there remain limits to the scope of reinsurance treaties. To maintain well diversified portfolios, reinsurers typically will not reinsure exposures over particular durations (commonly two years) and restrict exposures from individual countries and industries to a risk weighted portion of the portfolio. Depending upon the timing of a transaction and the existing reinsurance portfolio, this can limit the availability of reinsurance for credit risks in particular countries and industries.

Table 2.3: Private market reinsurers

Reinsurer	Principal shareholders	Principal office	Core reinsurance lines	Countries with offices	Staff	Credit rating
Munich Re	Publicly listed on all German stock exchanges (Allianz owns 9.4%)	Munich, Germany	• Property-casualty • Life and health	>50	40,000	S&P: A+ Moodys: Aa3 Fitch: AA- AM Best: A+
Swiss Re	Publicly listed on SWX	Zurich, Switzerland	• Property and casualty • Life and health • Financial services	>30	8,640	S&P: AA- to A+ Moodys: Baa1 to A1 AM Best: A- to A+
Hannover Re	Publicly listed on all German stock exchanges (HDI owns 50.2%)	Hannover, Germany	• Property/casualty • Life/health • Financial reinsurance • Specialty insurance	18	2,800	S&P: BBB to A+ AM Best: A- to A

Medium to Long-Term Market

Table 2.4: Summary of medium to long-term market products

Product	Description
Internal financing	Firms draw upon their existing general funds to make capital investments.
Long-term loans	Borrowing funds from domestic and international banks.
Bonds	Larger firms and governments raising capital through the issue of bonds, circumventing the banking sector and borrowing directly from investors.
Project finance	Provision of a loan to a corporate vehicle. Repayments are designed to match the cash generating profile of the asset. Security is restricted to the project and capital asset.
Medium to long-term credit insurance	Covers the exporter or financier for default by a purchaser over a longer period.
Political risk insurance (PRI)	Provided for investments and related financing and provides coverage for losses arising from political events as defined by the insurance contract.
Reinsurance	Insurance for insurers. All primary insurers of political risk (except Sovereign) have reinsurance treaties with the major reinsurers.

Internal financing

Firms draw upon their existing general funds to make capital investments. For large investments, having the funds available can be particularly problematic. In some industries, however, it is common practice to draw upon a firm's general pool of internal funds to pay for investments, whether raised as debt or equity. For example, in the mining and oil and gas industries, it is common for larger firms to draw upon internal funds for investments. Whether a firm will choose to finance a capital investment from its own funds depends upon the commercial viability of the project, the funds available to the firm and the appetite of its shareholders to assume investment risks.

Long-term loans

Firms or governments can borrow funds for particular capital investments. Loans are available from all domestic banks and international banks. A bank's willingness to provide a loan depends upon the creditworthiness of the borrower and the borrower's available collateral. Banks can provide loans in syndicate to make the size of an exposure easier for each member of the syndicate to provide, and can roll-over short-term facilities to manage the duration of a loan.

Bonds

Larger firms and governments can circumvent the intermediation of the banking sector and borrow directly from investors in bond markets. The bonds referred to in this section are distinct from performance bonds, which are a surety for contractual performance by service providers and are discussed below under 'Bonding.' The key distinction between loans and bonds is the capacity for bondholders to sell their investment to a third party. As with loans, the availability of bonds depends upon an investor's perceptions of a borrower and the borrower's available collateral. Because of the large costs associated with issuing bonds, they are typically only used for large raisings by corporate entities, or by governments who can develop economies across multiple issues. The tradability of bonds can also allow borrowers to access funds not

normally available through financial intermediaries. For example, a corporation can issue high yield, high risk (due to the high risks of the project being financed or the already high borrowing relative to collateral of the borrower) debt at discounted prices to investors that would be unacceptable to financial intermediaries. Additionally, the bond market can increase the depth of the loan market – loans can be bundled and sold into bond markets through a process known as securitisation.

Project finance

As discussed in the previous chapter, project financing is the provision of a loan to a corporate vehicle. The risk to the financial institution of not being repaid is assessed against the corporate vehicle's creditworthiness. Given that the corporate vehicle only owns the underlying project, its creditworthiness depends upon the profitability of the project. As a result, the loan is flexibly structured to reflect the profitability of the underlying project. Repayments are designed to match the cash generating profile of the asset, rather than the normal fixed period payments associated with a traditional loan. Security is restricted to the project and capital asset itself, with little recourse to the ultimate owner or borrower.

Project financing can be particularly attractive for private sector entities lending to foreign governments against whose assets private entities have no recourse. While the concept has existed for at least the beginning of this century, the market for project finance has experienced dramatic growth over the last decade. In 2005, project finance borrowing reached US$140.3 billion, up 20.2 per cent on 2004 and 60.4 per cent on 2003.[122] The primary driver for this growth has been the wave of privatisation of public entities globally beginning in the 1980s (that has provided the necessary corporate vehicles) and the disillusionment of private financiers with public guarantees following successive debt crises.[123] Project financing is common in the power, transport, telecommunications, and oil and gas sectors[124] – traditionally public utilities provided directly by governments. The current liquid global environment for funds discussed above, has made project finance a readily accessible alternative to traditional loans, provided the institutional framework is in place in the country in which the investment is being made.

Medium to long-term credit insurance

As with short-term credit insurance, medium to long-term credit insurance covers the exporter or financier for default by a purchaser. Because the insurance covers a longer term and typically several payments over that term, the structure of the underlying lending and insurance is typically more complicated than the short-term market. Nevertheless, the essence of the insurer assuming the risk of default, both for commercial or political reasons, is the same.

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[122] Thomson Financial, *Global Project Finance Review: Fourth Quarter 2005*, 2005, p. 1; Thomson Financial, *Global Project Finance Review: Fourth Quarter 2004*, 2004, p. 1.
[123] G Kuhn et al., *Officially Supported Export Credits: Recent Developments and Prospects*, International Monetary Fund, Washington DC, 1995, p. 18; International Financial Consulting, op. cit. note 24, pp. 5-6.
[124] See Thomson Financial, 2005, op. cit. note 121, p. 1; Thomson Financial , 2004, op. cit. note, p. 1.

As with the short-term credit insurance market, the demand for medium to long-term credit insurance depends upon the risk appetite of the exporter or financier. Exporters may be unfamiliar with a foreign purchaser or perceive the risk of purchasers in a particular country to be too high. Likewise, banks may not be willing to assume the political risk associated with certain countries and not extend finance without insurance.

In 1954, ECGD began providing unconditional bank guarantees (with recourse to ECGD rather than the exporter) for exports of capital goods.[125] Other ECAs followed suit. The market of providing longer term credit insurance has traditionally been the domain of ECAs and remains so. For loans in excess of five years this remains the case. Unlike the short-term business, with its short duration, high turnover and low values, guarantees for medium to long-term loans tie up large amounts of capital (for prudential regulatory requirements) that can generate better returns for risk in shorter term markets. Additionally, it is extremely difficult for insurers to foresee events over such a time horizon and manage the exposures in their portfolio accordingly.

It is not a common occurrence for exporters or financiers to seek credit insurance for exposures of more than a year. Likewise, most support for medium to long-term projects is sought for long-term infrastructure projects with time horizons over five years. This is simply a reflection of the typical nature of the goods exported that constitute these markets. As discussed above, in the current benign credit environment, credit insurers have supported transactions of increasing duration on a case-by-case basis. While there is anecdotal talk of terms extending out to five years, this appears more of an exception than a rule. Goods that fall outside of the common repayment periods – between two to five years – may be unserved by either the private credit insurers or ECAs, which may be focused by their mandates on long-term capital investments in excess of five years.

Political risk insurance

PRI is provided for investments and related financing and, unlike credit insurance which covers default per se, only provides coverage for losses arising from political events as defined by the insurance contract. The classes of events typically covered by political risk insurance are: war damage and political violence; government expropriation or confiscation of assets; government frustration or repudiation of contracts; and inconvertibility of foreign currency or the inability to repatriate funds. The exact events covered, and the definition of those events, varies from contract to contract.

The private market providing PRI has grown substantially over the last two decades.[126] Nevertheless, PRI was used for only a small portion of emerging market foreign direct investment during the 1990s.[127] Demand for PRI is driven by investor and financier appetite to assume the risks associated with investing in a particular

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[125] Pearce,op. cit. note 1, p. 1.
[126] Wang et al., op. cit. note 6, p. 13; K. Hamdani et al, *An overview of Political Risk Insurance*, Federal Reserve Bank of New York, 2005, p. 5; G West and K Hammel, 'Whither the political risk insurance industry?' in Appendix II pp. 206-30 of T. Moran and G. West, *International Political Risk Management*, World Bank, Washington, 2005, p. 213.
[127] Hamdani et al,,ibid, p. 2.

country. Financiers may regard PRI as a precondition to investing in projects in particularly high risk countries in Asia, Latin America and Africa. For some industries such as the mining industry, however, it is common for shareholders to assume the risks associated with investing in foreign countries. This is also common for larger multinational companies which have diversified exposures to particular countries. For major growth export markets such as China and India, investors typically carry risks themselves. PRI is a particularly attractive option for project finance because commercial and political risks are separated via the corporate vehicle and can be managed by parties specialised in those risks (financiers in the case of commercial risk and specialised insurers in the case of political risk).

PRI was first issued by the US government after World War II as part of the Marshall Plan to encourage US investment in Europe which was perceived to be politically unstable.[128] Other ECAs followed suit and the public sector was the primary provider of PRI for most of the 20th century.[129] A private market emerged from underwriting syndicates at Lloyds in the 1970s,[130] and grew substantially during the 1990s. During the 1990s foreign direct investment to developing countries (the primary recipient of PRI) increased dramatically and drove increased demand for PRI.[131] Although the market is not dominated and carved out as clearly as that for short-term export credit insurance, there are a number of major private sector providers: American International Group, Lloyd's, Sovereign, Chubb and Zurich.[132]

Table 2.5: Major private sector providers of short-term insurance

PRI provider	Principal shareholders	Principal office	Core PRI lines	Countries with offices	Staff	Credit rating
American International Group	Publicly listed on NYSE	New York	• Confiscation, expropriation and nationalisation • Currency inconvertibility and non-transfer • Political violence • Contract frustration due to political events • Wrongful calling of guarantees and bonds	130	35,000	S&P: AA Moodys: Aa2
Lloyd's	See discussion below					
Sovereign	ACE Limited (which is listed on the NYSE)	Bermuda	• Expropriation • Currency Inconvertibility / Exchange Transfer • Political Violence • Sovereign and	1	10	S&P: A+ Moodys: Aa3 AM Best: A+

[128] West and Hammel, op. cit. note 125, pp. 215-6.
[129] Hamdani et al, op. cit. note 125, pp. 5-6; G. West and Hammel, op. cit. note 125, pp. 216-8.
[130] West and Hammel, ibid, p. 218.
[131] Hamdani et al, op. cit. note 125, p. 6; G West, 'Political risk investment insurance: a renaissance' *Journal of Project Finance*, 1999, vol. 5(2), p. 2; G. West and Hammel, op. cit. note 125, pp. 207-12, 219.
[132] West, ibid, p. 6, Exhibits 4 and 6; http://www.sovereignbermuda.com/pri.html (28/9/06).

PRI provider	Principal shareholders	Principal office	Core PRI lines	Countries with offices	Staff	Credit rating
			Sub-Sovereign Non-Payment • Unfair Calling of Bonds • Non-Repossession of Aircraft or Mobile Equipment			
Chubb	Publicly listed on NYSE	New York	• Contract frustration • Expropriation • Wrongful calling of guarantee	29	11,800	S&P: AA Moodys: Aa2 AM Best: A++
Zurich	Zurich Financial Services	Zurich	• Expropriation • Political violence • Currency inconvertibility	120	800	S&P: A+ Moodys: A1 Fitch: A+ AM Best: A

In addition to the traditional insurers, Lloyd's also provides insurance. Lloyd's involvement is noteworthy because it is not an insurance company, but an insurance market for members. Lloyd's itself does not provide capital, rather its members (both individual and corporate) channel capital through agents or brokers who syndicate the available capital to meet the requirements of particular projects. This flexibility is well suited to the PRI market because it allows tailoring of the coverage to match the needs of the particular project. Additionally, syndication is a natural feature of the market, allowing it to digest larger transactions. Berry, Palmer and Lyle, JLT, AON, FirstCity and Marsh are examples of brokers with high levels of involvement in PRI. Chaucer and XL are examples of syndicates that underwrite PRI.

The appetite for these insurers (including syndicates at Lloyds) to assume risks is limited by the duration, capacity, country and type of exposure.

Since the mid 1990s, the duration that private insurers are willing to cover has expanded dramatically.[133] Traditionally, private insurers limited their exposures to one to three years.[134] More recently, private insurers have covered up to fifteen years for particular investments. Appetite to provide this sort of coverage remains piecemeal and ECAs still carry the majority of business for durations in excess of ten years.

Due to limits on the amount of capital available to set aside to meet potential losses (for prudential regulatory purposes), insurers limit their exposure to individual projects. These limits are all below US$1 billion (and typically under US$100 million), and for large projects it is common for syndicates of private insurers and ECAs to combine capacity. Syndication can also encourage private sector PRI providers to extend the duration of cover provided. For durations over five years, PRI providers gain 'comfort' from the involvement of an ECA.

[133] West and Hammel, op. cit. note 125, p.219.
[134] ibid, pp. 207-12; West, op. cit. note 130, p. 7.

To maintain well diversified portfolios, private insurers will limit their aggregate risk weighted exposure to particular countries and regions.[135] As a consequence, insurance may not be available for particular countries, at particular points in time when the existing exposure to a particular country or region is at or near that limit.

Cover for particular types of exposure are often perceived as too risky and excluded from PRI contracts. For example, cover of terrorism events was commonly excluded from PRI contracts after 11 September 2001. Some insurers cover such events through separate policies, such as stand alone terrorism insurance.

Reinsurance

All the primary insurers of political risk (except Sovereign) have reinsurance treaties with the major reinsurers discussed above. The limits to the appetite of the primary insurance market discussed above mirror the limits to the availability of reinsurance. The larger sums of money required for investment in capital and the less diversified, more 'lumpy' nature of the portfolios does not make reinsurance an attractive option for the traditional reinsurers. The size and duration of exposures ties up large amounts of capital (for prudential regulatory purposes to meet potential losses) for long periods. Reinsurers see shorter term, better diversified exposures as providing higher returns on the amount of capital that must be set aside. For example, the short-term credit insurance portfolio is better diversified and is rolled over several times a year. Additionally, it is difficult to foresee events over a time horizon exceeding five years and adjust the portfolio of country exposures in response to political events.

The scope of reinsurance treaties reflects these limits. Reinsurers require primary insurers of political risk to keep a sizeable share of their exposures (often around 50 per cent). To maintain well diversified portfolios, reinsurers will limit the exposures from various countries passing through the treaty according to a risk weighted portion of the portfolio. There are also limits on the duration of exposures with reinsurers, particularly for political risks exceeding five years. Occasionally, insurers of political risk will use facultative reinsurance to cover exposures that do not fit within the limits defined by the treaties.

Bonding

The bond referred to in the following discussion is a sum of money is set aside (often with the purchaser) as a guarantee that specified obligations (usually in a contract) will be met. Should the exporter fail to meet those obligations, the purchaser is entitled to the bond. Often, the bond is an amount retained by the purchaser out of the price paid to the exporter and paid at a later stage if the specified obligations are met. The bond gives surety that the specified obligations will be performed. While remedy could be sought for a breach of warranty or contract, it can be expensive and time consuming to bring such an action. In contrast, a bond with expressly defined obligations in a contract is readily accessible, particularly if the bond is in the possession of the purchaser.

[135] Hamdani et al, op. cit. note 125, p. 6 ; West, ibid, p. 6.

Bonds are particular to service industries, mainly engineering and construction. For goods such as commodities or equipment, a warranty (that does not require a sum to be set aside) is usually sufficient. Bonds may be involved in medium to long-term investments during the construction of the infrastructure or plant. The obligation in this instance is not between the investor and bank (in contrast to financing a medium to long-term investment), but between the investor and contractor. Requiring bonds is also more common in some countries, due to cultural or legal reasons. For example, some governments require performance bonds as a matter of policy for infrastructure projects.

The level of bonding required varies between purchasers and industries and is typically up to 20 per cent, although it can be significantly higher in some countries.

Bonding is commonly used before the award of a contract in competitive bids to ensure that only serious bidders with financial capacity participate (bid bonds). Bonding is also used after the award of a contract to guarantee the performance of the end product (performance bonds). Some performance bonds have a ‘cascading effect’, in that half of the bond would be held until after testing of the obligations (acceptance testing) took place and the remaining half for the remainder of the warranty.

Internal financing

Providing bonds ties up the cash of service exporters (or temporarily deprives them of cash they would receive from the sale) that can otherwise meet payments of suppliers and contractors. For this reason, they are an undesirable drain on the working capital of the exporter. Additionally, the exporter is exposed to the risk that the bond could be withheld, even if the specified obligations are met and can not be regained without an expensive and time consuming legal action – a situation referred to as unfair calling. Suppliers of niche products or services can often push back on demands for bonds by purchasers. In contrast, suppliers in competitive bidding situations for non-niche products often must match the terms offered by competitors and meet demands by purchasers for bonds.

Bond facilities

As discussed above, exporters can obtain working capital facilities from banks to provide cash to meet payments while they await receipts from purchasers. In addition to general working capital facilities, specific facilities to meet bonding commitments are available. Generally, bonding facilities cover several bonds up to a limit on a rolling basis (such that as bonds expire and are repaid, other bonds may be offered provided the limit is not exceeded). General working capital and bonding facilities are a common service in corporate and business banking, and are provided by almost all domestic and international banks.

Bonding facilities are also provided by almost all domestic and international insurers. Bonds can be viewed from the perspective of a creditor such as a bank, as a loan to provide working capital. Alternatively, from the perspective of an insurer, a bond is a contingent claim by the purchaser. In this sense, it is comparable to other risks for which insurance is provided and capital set aside by the insurer.

A bank or insurer's decision to provide working capital for bonds is primarily based on an assessment of the credit risk of the exporter's business as a whole – the likelihood of default and the security available if there is a default. In the service industry, the likelihood of default does not depend so much upon the viability of a particular business model, but the faith that can be placed in the exporter's ability to meet the specific criteria. For this reason, banks will generally be more comfortable with lending to larger, well established businesses with a successful track record of meeting client specifications. For fast growing SMEs, limited security and a short history of performance can restrict access to working capital for bonding. Insurers view the claim to a bond as a contingency and place greater emphasis on the ability of the exporter to meet the specific criteria. In fact, insurers are able to provide unsecured facilities for bonds. Insurers can be an alternative for exporters that have reached the limit of working capital available from a bank due to available security.

Despite this general availability, there are limits to the appetite to provide bonds to certain countries and for certain durations. Banks or insurance companies may be uncomfortable with the risk of unfair calling in particular countries. Additionally, there may be certain legal requirements for providing bonds in particular countries. For example, domestic banks in the purchaser's country may require that the bond be denominated in a particular currency, or deposited in a locally registered or authorised branch. Banks and insurance companies are generally reluctant to tie up capital for durations in excess of five years. Although in the current liquid environment, this limit has been creeping outwards and bonding facilities may be available on a case-by-case basis for up to seven years.

Unfair calling insurance

Bonds provided under terms that offer a broad discretion for their retention are generally referred to as unconditional. For unconditional bonds and in particular legal jurisdictions where access to judicial remedies is costly and time consuming, the risk of unfair calling may be high. Exporters or banks may not be willing to assume such risks with their working capital (or loan facility in the case of a bank).

The private market treats unfair calling as a form of PRI – it is a form of contractual frustration or repudiation by government. While viewed as a form of PRI, it is not limited to acts by foreign governments and can cover commercial acts by non sovereign entities (in many cases the purchaser of the service will, however, be a foreign government). It is available from the major political risk insurers and a number of other international insurers. It is subject to similar limits in duration and country exposures as normal PRI.

Conclusion

This chapter discussed the dominance of the public sector in the market for financing and insuring exports during the 20th century. During the 1990s, this role was usurped by financing and insurance from private market providers.

Both short-term and long-term finance are available for commercially viable exports.

A handful of primary insurance companies (Coface, Euler Hermes, Atradius and AIG) are now the primary providers of insurance in the short-term credit market. Some governments have responded by privatising this area of their ECAs' activities.

With respect to the medium to long-term market, the 1990s saw the emergence of a number of significant providers of PRI (Sovereign, Zurich, Chubb, Lloyds, and AIG). While the appetite of these insurers to assume political risks has grown, it remains limited by transaction size, duration, country, industry and type of risk. Transaction size limits mean that syndication is a common feature of this market. For transactions over five years, ECA support allows private insurers to syndicate and provides comfort for risks. While private insurers have taken on exposures exceeding ten years, this has been on a limited basis and exposures of this duration remain the focus of ECAs. Similarly, credit risks exceeding two years are only covered on a piecemeal basis and remain the domain of government ECAs.

The private sector has a long history of involvement in bonding facilities which are available from most domestic and international banks as a form of working capital. Additionally, insurers provide facilities which view bonds as contingent claims and need not be secured. These facilities may be available for exporters that have reached the limit of their security for bank financing. Unfair calling insurance is available from the private market as a type of PRI. Unlike general PRI, unfair calling insurance can cover the commercial risk of a calling by a non-sovereign entity. In common with PRI, there are limits to the duration and country of exposure.

As highlighted at the beginning of this chapter, these observations should be considered in light of the current highly liquid global market for finance and the current benign levels of credit risk. Private market appetite for finance and insurance may retreat in response to global economic conditions, such as a fall in liquidity or increase in commercial or political risks. This would likely have limited impact on the short-term market which is attractive business for insurers and reinsurers, and have the most impact on the medium to long-term end of the market where private market support is already buttressed by ECAs. Over time, the private market may become more comfortable with longer term risk and assume an increasing portion of ECA activity, but the intransigent problems discussed above mean that there is likely to remain a portion of business that will always be the domain of government support. This business will simply expand and contract with the global credit environment.

CHAPTER 3: DOMESTIC PRIVATE MARKET DEVELOPMENTS

Introduction

This chapter outlines trends over the last two decades in the domestic market in which the Export Finance and Insurance Corporation (EFIC) operates. Additionally, it details developments in that market since the last review in 2003. Developments in the Australian market mirror those detailed in the last chapter for the international market.

There are no publications, except for previous government reviews, that discuss the state of the export credit and insurance environment in Australia. As a result, observations in this chapter are a synthesis of information gathered during in-confidence meetings with market participants during the public consultation process conducted as part of this review and from public submissions received during the review. A list of participants in the public consultation process and of submissions can be found in Annex B.

Export Credits and the Private Market

Private market developments in Australia mirror those internationally. This should not come as a surprise, given the global nature of financial capital. As discussed in Chapter 2, insurance of credit and political risks has traditionally been the domain of government-backed export credit agencies (ECAs). In Australia, as in the rest of the world, private market capacity to insure both risks grew during the 1990s.[136] In response, the Australian Government privatised part of the business of its ECA, EFIC. Discussions with market participants indicate that the presence of the private sector has continued to strengthen during the past few years.

The high liquidity, low credit risk environment discussed in Chapter 2 also characterises the situation in Australia. This was confirmed by all financial institutions and insurers visited during public consultations. As with the previous chapter, observations about the private market discussed in this chapter should be considered in light of this context. These observations are made at a high point in global and domestic liquidity.

Exporters and industry groups consulted consistently noted a shift in the nature of Australian exports. There was a trend for Australian businesses to shift aspects of their manufacturing overseas in order to take advantage of cheaper labour and the availability of unskilled labour overseas. There was also observed to be a trend towards international joint ventures, where Australian companies provided technology expertise (intellectual property) and foreign joint venture partners provided economies of scale, distribution and sales networks and capital.

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[136] Baker and Hallinan, *Review of Export Credit and Finance Services*, 2001, pp. 9-10, 13-14.

As with Chapter 2, discussion of private market developments will be segmented into the short-term and medium to long-terms ends of the market and the market for bonding.

Short-Term Market

Deferred payment for exports

An absence of reliable statistics means that it is not possible to generalise about the proportion of exporters that extend credit terms and the duration of credit terms provided. Rather, the factors that influence the choice by exporters to allow purchasers to defer payment discussed in the last chapter are equally applicable to Australian exporters. Deferred payment is favourable for purchasers, because it extends working capital financing, and is generally considered undesirable for exporters, because it creates a drain on their working capital. Exporters that supply niche products generally were able to require up front cash payment. Other exporters had to match the conditions offered by competitors with deferred payment terms being one element of the 'competitive package' being offered.

Letters of credit

As discussed in Chapter 2, letters of credit (LCs) are issued by foreign banks and international banks in support of purchasers of Australian exports. The four major Australian banks (Commonwealth, National Australia Bank, Westpac and ANZ) and a number of the mid-tier Australian banks (e.g. St George, Suncorp and BankWest) advise and confirm letters of credit. Additionally, a number of international banks with operations in Australia are available to advise or confirm letters of credit for Australian exporters (e.g. HSBC, BNP Paribus, Rabo Bank). Availability of LCs and advisory or confirmation services were not indicated by any consulted party to pose a problem for exporters.

As discussed in Chapter 2, availability of letters of credit and related services is primarily an assessment of credit risk. In the case of advising or confirmation, the relevant credit risk is that of the overseas bank issuing the LC for the purchaser. Banks will occasionally go 'off cover' for some countries or require credit insurance. Additionally, banks must be comfortable with the documentation procedures of the exporter.

Factoring and discounting

There are a number of specialised finance businesses in Australia that will factor or discount foreign receivables. Discounting could provide an attractive alternative for small to medium-sized exporters (SMEs) that lack the credit history and security to obtain working capital facilities from banks. A number of SMEs visited as part of the public consultations process were reluctant to accept a discount on the value of their receivables.

Working capital facilities

Working capital facilities and overdrafts for exporters are available from all Australian and international banks that provide business banking. As discussed in Chapter 2, a bank's decision to provide a working capital facility is primarily based on an assessment of the credit risk of the exporter's business, that is, the exporter's credit history and the security available if there is a default. Larger exporters that were consulted did not express any difficulties with obtaining such facilities.

Fast growing SMEs often have limited capital assets against which to secure borrowing and have only exported for a short period of time or sporadically. A number of SMEs consulted stated that, for these reasons, they had experienced trouble accessing sufficient working capital from banks.

Exporters with an annual income of $30 million or less can access the export market development grant (EMDG) provided by Austrade to help alleviate working capital problems. The EMDG reimburses up to 50 per cent of eligible export promotion expenses above a threshold of $15,000. There was a high level of awareness of the EMDG among SMEs. Typically, exporters indicated that they had already accessed the grant.

On 5 July 2006, EFIC launched a facility designed to extend the existing working capital facilities of exporters with an annual turnover of up to $50 million, EFIC Headway. EFIC Headway guarantees a loan to an SME for working capital up to the value of an SME's annual turnover. The guarantee allows the receivables to be treated as collateral by banks providing existing working capital facilities and extend (generally up to 20 per cent) further working capital. The awareness among SMEs consulted during the Review of the Headway product and EFIC in general was low. Commonly, there was a perception within this group that EFIC had ceased to exist after the sale of its short-term credit insurance business to Atradius.

Short-term credit insurance

Australia's first ECA, the Export Payments Insurance Corporation (EPIC) was established to provide credit insurance to exporters.[137] EPIC's successor, EFIC, has been the dominant insurer in the Australian market for export credit insurance.

During the late 1990s, a number of private sector insurers established operations in Australia to insure short-term export credits (AIG, Coface, Gerling, QBE, and HIH).[138] Even in the presence of private sector entrants, however, EFIC maintained its dominant market share. In 1999-2000, EFIC was estimated to underwrite 60 to 65 per cent of export credit insurance premiums.[139] The 2000 EFIC Review (2000 Review) attributed EFIC's dominant market share to the recent timing of the entrance of the new players and EFIC 'crowding out' the private sector, and concluded that

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[137] See *Export Payments Insurance Corporation Act (1956) (Cth)*, s 13.

[138] V Baker and C Hallinan, *Review of Export Credit and Finance Services: Australian Developments in Export Credit and Finance Services*, 2001. pp15-6; Steering Committee Report, *Review of Export Credit and Finance Services*, 2001, pp. 3-4, 27.

[139] Steering Committee Report, p. 27.

there was sufficient capacity in the private sector to meet Australian exporter demand for short-term credit insurance.

As a result, the Australian Government announced that EFIC would enter into an alliance for its short-term credit insurance business with a private insurer.[140] In October 2001, Atradius's predecessor NCM was selected by a tender process to reinsure EFIC's short-term business (on the commercial account) and to provide EFIC with certain resources to enhance its operations. On 14 August 2003, the Australian Government announced the divestment of EFIC's credit insurance business to Atradius after the Australian Government, EFIC and Atradius's predecessor NCM agreed to certain performance criteria. After the divestment of its short-term credit insurance business, EFIC was directed by the Minister for Trade not to provide short-term credit insurance on its commercial account.

Despite suggestions, at the time of the 2000 Review, that other private operators might enter the market,[141] there have been no new providers of short-term credit insurance since the 2000 Review. Three of the four major international credit insurers now operate in Australia – Atradius, AIG and Coface.[142] In addition, the Australian insurer QBE has a short-term credit insurance division. Of these competitors, Atradius and QBE share the majority of the market for short-term credit insurance in Australia.

Parties consulted as part of this review indicated that private sector capacity is adequate to service demand from medium to large exporters. The only evidence of a narrowing of the scope of Atradius's operations was the general observation that private sector insurers service clients in a more commercial manner than EFIC does. That is, they take a more clinical approach to the assessment of risk and return, and will not assume marginal risks to meet policy objectives such as promoting exports. The private market participants were also observed to have access to better databases of credit information from which to assess credit risks.

Some SMEs consulted as part of the review expressed difficulty with accessing short-term credit insurance from the private sector. The high level of overhead required to insure low value or sporadic exporters was argued by some to deter private sector interest. SMEs would not be willing to pay the premiums necessary to generate sufficient return on this more costly business. Companies with a turnover from $5 million to $50 million were perceived not to be well serviced by the market and some suggested that the private market would not look at a company unless it had a book of receivables exceeding $10 million. Both Atradius and QBE, however, discussed recent initiatives using on-line application forms and databases to allow them to service SMEs at a lower overhead.

SMEs have a limited understanding of the credit insurance industry. Some had unreasonable expectations about the risk a private sector financial institution or Australian Government should assume and the price of that risk.

[140] See EFIC *Annual Report* 2003. p. 23.
[141] Baker and Hallinan, op. cit. note 137, p. 10.
[142] HIH went into provisional liquidation in March 2001, and Swiss Re acquired NCM and merged it with Gerling Credit Insurance Group in 2004 to form Atradius.

Despite fairly comprehensive cover by the private market, the limits to the availability of short-term credit insurance (in terms of duration and countries) that apply in an international context also apply in an Australian setting. The private market generally has only a limited, piecemeal appetite to insure exposures of a duration exceeding two years and does not provide cover to certain high risk countries such as Iraq.

Reinsurance of short-term credit

Australian providers of short-term credit insurance reinsure almost all of their risks through reinsurance treaties with the major reinsurers identified in Chapter 2. None of the insurers consulted during this Review indicated any difficulties with their reinsurance arrangements. As discussed in the previous chapter, there remain limits to the scope of reinsurance treaties. To maintain well diversified portfolios, reinsurers typically will not reinsure exposures over particular durations (commonly two years) and restrict exposures from individual countries and industries to a risk weighted portion of their portfolios. Depending upon the timing of a transaction and the existing reinsurance portfolio, this can limit the availability of reinsurance for credit risks in particular countries and industries.

Medium to Long-Term Market

Traditional financing

In the current highly liquid environment, funds for investment are readily accessible via equity raisings, loans or bonds. Several corporations consulted during the Review stated that their available funds exceeded their investment opportunities and they either intended to or were considering returning capital to shareholders via various mechanisms. For almost all parties, the only limits to accessing traditional forms of financing were normal commercial limits relating to creditworthiness and available security.

Exporters in the shipbuilding industry stated that they had difficulty in obtaining financing for their purchasers. Australian shipbuilders face competition from a number of international operators that provide financing, mostly through foreign ECAs, to purchasers. There are particular characteristics of ships that make them unattractive for financing by commercial lenders. Ships are a mobile capital asset making them poor security for loans and there is an international flight risk when a lender attempts to enforce its security against a vessel. The asset value after the lengthy loan terms used for ship transactions is uncertain, making the value of security difficult to assess. In certain segments of the shipping industry, financiers are reluctant to finance ships without credit insurance.

Project finance

Australia has considerable experience with project financing, built on the back of state and federal privatisations during the 1990s following Australian Government National Competition Policy reforms. Despite a downturn during the Asian financial crisis, the use of project finance by Australian companies has grown in line with project financing internationally. During 2005, Australian companies borrowed US$8.9 billion in project finance, or 35.7 per cent of project financing in the Asia-

Pacific (including Japan).[143] Although these figures do not distinguish project financing of exports from project financing of domestic projects, they indicate the depth of experience of Australian companies and the Australian finance industry with project financing. Project financing is available from all the major Australian banks (National Australia Bank, Commonwealth Bank, ANZ and Westpac) and a number of international investment banks (e.g. ABN AMRO, JP Morgan, Mizuho Financial Group, etc) for Australian companies investing in capital assets overseas or overseas purchasers of Australian capital assets. Parties consulted during the Review consistently stated that project financing was an accessible alternative to commercial lending depending upon the commerciality of the underlying project and the legal infrastructure in the importing country.

Medium to long-term credit insurance

The volume of exports on payment terms exceeding two years is a small portion of the credit insurance market (anecdotally less than five per cent). As discussed above, private sector insurers have only a limited, piecemeal interest in insuring repayments over periods in excess of two years.

EFIC has, since its conception as EPIC, provided credit insurance for capital goods.[144] EFIC retained the business of insuring credit exposures in excess of two years after the sale of its short-term credit insurance business to Atradius. It remains the primary insurer for exposures of this duration whether insurance to the exporter for default by the purchaser (through medium term payments insurance) or the financier for default by the purchaser (through an export finance guarantee) of Australian exports of capital assets. No insurer consulted during the Review indicated that EFIC was taking away business in this segment of the market. Medium term export finance guarantees for ships were identified as an important pre-condition of financing support for some segments of the shipbuilding industry. As discussed above under 'Traditional financing', financiers are reluctant to finance certain segments of the shipbuilding industry without credit insurance.

Political risk insurance

EFIC's predecessor, EPIC, issued its first PRI product in 1967[145] and for a long time was the only provider in the Australian market. Mirroring the trend in the international marketplace discussed in the previous chapter, private sector providers (AIG, Lloyds, Zurich and Sovereign) established presences in Australia in the 1990s.[146] Since the 2000 Review, these insurers have maintained their presence in Australia and all the major PRI insurers identified in the last chapter (AIG, Lloyds, Zurich, Sovereign and Chubb) are available to provide PRI to Australian exporters.

The same limits relevant to the international market apply to Australian exporters – capacity, duration, country and type of exposure. The duration of exposures that insurers are willing to accept has expanded with the possibility of up to 15 years for

[143] Thomson Financial, 2005, op. cit. note 121, p. 9.
[144] See discussion in Export Payments Insurance Corporation, *6th Annual Report & Financial Statements*, 1962, pp. 5-7.
[145] See Export Payments Insurance Corporation, *Annual Report*, 1968, p. 10.
[146] Baker and Hallinan, op. cit. note 137, p. 13.

certain projects. But generally, private market insurers are unwilling to ensure exposures in excess of ten years. For exposures of five to ten years, private market insurers stated during consultations that they could overcome capacity limits and gain comfort from syndication with other insurers and ECAs such as EFIC. Additionally, there are certain countries that pose too great a risk for insurance or, at a given point in time, may have reached the limit of exposure available from a particular insurer.

Reinsurance

Reinsurance of political risk insurance (PRI) is available on a treaty basis and a more limited facultative basis from the limited pool of reinsurers identified in the previous chapter. As discussed, the larger sums of money required for investment in capital and the less diversified, more 'lumpy' nature of the portfolios does not make PRI business an attractive option for the traditional reinsurers. There are limits on the size, country and duration that reinsurers impose on reinsured political risks to maintain diversified portfolios.

Bonding

Internal financing

Reliable statistics on the amount of bonds provided by Australian exporters are not available. Rather, exporters consulted during the Review indicated factors that influence whether exporters are required to provide bonds. As discussed in Chapter 2, bonds are an undesirable drain and an additional risk to the working capital of an exporter. Suppliers of niche products or services can often push back on demands for bonds by purchasers. In contrast, suppliers in competitive bidding situations for non-niche products must often match the terms offered by competitors and meet demands by purchasers for bonds.

Bond facilities

General working capital and bonding facilities are a common service in corporate and business banking, and are provided by the four major Australian banks (Commonwealth, National Australia Bank, Westpac and ANZ), a number of the mid-tier Australian banks and a number of international banks. Availability of facilities is subject to normal commercial limits according to creditworthiness and available security. Insurance companies (including QBE, Vero, Chubb, Liberty and AIG), with a greater emphasis on the ability of the exporter to perform the contracted obligations, can provide unconditional bonds to further the value of bonds that are accessible. As discussed in the previous chapter, there are limits to the appetite to provide bonds to certain countries and for certain durations. Generally, private market appetite for durations in excess of five years is limited. Often legal requirements in particular countries require a deposit in a locally registered or authorised branch. This can make availability contingent upon the branch network or cooperative arrangements (with overseas banks or insurers) of the bank or insurer concerned.

In 1978, EFIC's governing legislation was amended to enable it to support financial institutions providing bonds.[147] The new facility was intended to complement existing private market facilities by issuing indemnities to banks and insurers. EFIC has continued to be involved in the providing of bonds alongside the private sector. Several exporters consulted during this Review stated that EFIC focused strongly on the ability of the exporter to perform the contracted obligations supported by the bond. This was viewed to be a reflection of EFIC's focus on supporting Australian exports and its perspective as an insurer. As a result, EFIC has provided bond facilities to exporters that did not have sufficient assets for security or had already reached credit limits with existing banks.

Unfair calling insurance

As discussed in the previous chapter, the private market treats unfair calling as a form of PRI – it is a form of contract frustration or repudiation by government (although it can also cover the commercial risk of an unfair calling by a non-sovereign entity). It is available from the major political risk insurers, but is mostly channelled through Lloyds brokers. It is subject to the same limits in duration and country exposures as normal PRI.

EFIC introduced unfair calling insurance in 1978 along with its bonding facility to provide additional assurance to exporters.[148] EFIC has continued to provide this facility as private market appetite evolved over the last thirty years for shorter term PRI exposures.

Conclusion

Developments in the Australian market for financing and insurance of exports mirror those internationally.

The Australian market for credit is highly liquid and credit risk is also considered benign. Both short-term and long-term finance is available for commercially viable exports. SMEs and the shipping sector were identified as sectors that experienced difficulty in obtaining finance. Due to a lack of collateral and limited credit history, SMEs may be unable to access working capital financing. EFIC has recently introduced a product, EFIC Headway, partially to overcome these problems for exports that have existing working capital financing. It is to be seen whether this initiative will successfully address the working capital concerns of SMEs. A difficulty for EFIC will be its poor market presence amongst SMEs. Government supported competition in the global shipping industry, and certain intrinsic characteristics of ships that make them poor collateral, limit the availability of medium to long-term finance for ships from the private sector. Export finance guarantees are required for banks to finance the export of certain types of ship.

The divestment of EFIC's short-term credit insurance business has been successful. Discussion with exporters, banks and insurers confirm that there is adequate capacity in the private market to service demand. SMEs are one area of the market that claims

[147] See EFIC, 1979, *Annual Report* , p. 11.
[148] EFIC, 1979, *Annual Report*, p. 11.

to be poorly serviced due to high overheads and low return for private market insurers. It is difficult to see how the Australian Government could re-enter the short-term market and support SMEs without introducing a subsidy. SMEs also have a limited understanding of the credit insurance industry and have unreasonable expectations of risk and return to private and government providers.

Private market appetite for medium to long-term political risk has continued to increase, but remains limited by type, duration, country and industry. In general, private market insurers are unwilling to ensure exposures in excess of 10 years. For exposures of five to ten years, private market insurers can overcome capacity limits and gain comfort from syndication with other insurers and ECAs such as EFIC.

The medium to long-term market for credit insurance (both payments insurance and export credit guarantees) is only serviced by the private market on a piecemeal basis and remains a focus of EFIC support.

There is a deep private market capacity for bonding facilities. A number of insurance companies are available to provide bonds where banks have reached the limits of their appetite due to available security. The market is limited in duration to around five years and to certain countries. There is an overlap with the service provided by EFIC. Unfair calling insurance is available mostly through Lloyds brokers as a form of PRI (but also extending to the commercial risk of unfair calling by a non-sovereign entity) and is subject to similar limits to availability as general PRI.

As observed in Chapter 2, these observations are made at a high point in global and Australian liquidity. Over time, the private market may become more comfortable with longer term risk and assume an increasing portion of ECA activity, but there is likely to remain a portion of business that will always be the domain of government support. The extent of this business will expand and contract with the global and Australian credit environment.

CHAPTER 4: THE EXPORT FINANCE AND INSURANCE CORPORATION

Introduction

This chapter describes the Australian Government's export credit agency (ECA), the Export Finance and Insurance Corporation (EFIC). It briefly describes the history of EFIC and its predecessors and then elaborates on the legislative framework under which the current EFIC operates. It concludes by evaluating EFIC's performance in the 'market gap' since the last review.

History

The then Export Payments Insurance Corporation (EPIC) was established as a statutory corporation in 1956.[149] The corporation was to provide credit insurance to exporters that the private sector would not normally insure.[150] It was to do so with a view to encouraging trade with foreign countries while attempting to break even.[151]

EPIC was replaced in 1974 by EFIC.[152] In contrast to EPIC, which was overseen by a Commissioner,[153] EFIC is overseen by a board.[154] The replacement was intended to expand the range of financing and insuring activities that EFIC could engage in to allow it to compete with foreign ECAs.[155] EFIC also was granted broader powers. In addition to being able to provide credit insurance to exporters, EFIC had the power to insure financiers of exporters, insure overseas investments (i.e. provide political risk insurance (PRI)), guarantee tenders and performance, and lend to purchasers of Australian capital goods.[156] EFIC's powers were further amended in 1978 to allow it to provide performance bonds and unfair calling insurance.[157]

In 1985, EFIC's powers were transferred to the newly formed Australian Trade Commission which continued to provide financing and insurance under the EFIC name.[158] The Australian Trade Commission was also conferred the power to enter into reinsurance contracts for insurance it provided.[159] The Australian Trade Commission was also managed by a board structure but had broader powers relating to the facilitation of international trade[160] including providing advice to traders, establishing offices overseas, administering aid funds in support of exporters and providing grants to exporters.[161]

[149] *Export Payments Insurance Corporation Act 1956 (Cth)*, s 6.
[150] ibid, s 13.
[151] ibid, s 14.
[152] *Export Finance and Insurance Corporation Act 1974 (Cth)*, ss 7, 92-7.
[153] *Export Payments Insurance Corporation Act 1956 (Cth)*, s 7.
[154] *Export Finance and Insurance Corporation Act 1974 (Cth)*, ss 42-3.
[155] *Export Finance and Insurance Corporation* (1975) *First Report*, p.5.
[156] *Export Finance and Insurance Corporation Act 1974 (Cth)*, ss 22-41.
[157] See EFIC *Annual Report* 1979, p. 11.
[158] *Australian Trade Commission Act1985 (Cth)*, ss 35-44.
[159] ibid, s 34.
[160] ibid, s 8.
[161] ibid, ss 23-32.

EFIC was re-established as a separate body corporate in 1991 by the *Export Finance and Insurance Corporation Act 1991 (Cth)* ('the *EFIC Act*').[162] The discussion of EFIC's structure and operations in the remainder of this chapter are framed by reference to this governing legislation. EFIC was part of the Industry portfolio, but was shifted to the Foreign Affairs and Trade portfolio in 1998.

EFIC's Objectives

Statutory functions

The *EFIC Act* defines EFIC's three primary functions to include:[163]

- To facilitate and encourage Australian export trade by providing insurance and finance to exporters;
- To encourage banks and other financial institutions (carrying on business in Australia) to finance or assist financing of exports; and[164]
- To provide information and advice regarding financing or insurance of Australian exports.

These functions guide EFIC in the exercise of the powers detailed under the next heading. The exercise of EFIC's powers must be in pursuit of one of these functions.[165]

EFIC also has a function to manage the Australian Government's portfolio of outstanding aid or Development Import Finance Facility (DIFF) loans.[166] On 23 July 1996, the Australian Government announced the cessation of the DIFF program to help meet budget commitments, to remove what was identified as a subsidy to exporters and to improve the effectiveness of Australia's aid spending.[167] A number of loans made under mixed aid and export credit programmes remain outstanding and will run off of EFIC's accounts over the next decade. The Australian Government has assumed financial responsibility for these loans[168] which are administered by EFIC. Because these loans are being wound down, and mixed aid and credit are no longer provided by EFIC, this function will not form part of the discussion of this report.

In performing its functions, EFIC must comply with a number of duties detailed in s8 of the *EFIC Act*. Importantly, EFIC must comply with directions of the Minister.

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[162] ibid, s 6(1).
[163] *Export Finance and Insurance Corporation Act 1991 (Cth)*, s 7.
[164] ibid, s 7(1)(b) actually refers to 'export contracts' and 'eligible export transactions', the definitions of which are discussed below under 'EFIC's powers'.
[165] *Export Finance and Insurance Corporation Act 1991 (Cth)*, s 11(1).
[166] ibid, s 6(c).
[167] Senate Foreign Affairs, Defence and Trade Committee, *Inquiry into the Abolition of the Development Import Finance Facility*, 1991, p. 2.78-2.82.
[168] *Export Payments Insurance Corporation Act 1991 (Cth)*, s 66A.

EFIC's mode of delivery

In performing its functions EFIC's duties include:

- Do so in a manner that best assists the development of Australian exports;[169]
- Have regard to the desirability of improving and extending the range of insurance and finance available (whether from EFIC or otherwise) to exporters and those involved in exporting; [170] and
- Provide its services and products as efficiently and economically as possible.[171]

Hence, EFIC's function is not simply to finance and insure Australian exporters. EFIC must have regard to whether it can, through its powers, better assist the development of Australian exports in a different manner, or improve the range of insurance or finance available from other parties. For example, export finance guarantees (see discussion in Chapters 2 and 3 under 'Medium to long-term credit insurance') are intended to encourage private sector financiers to finance certain exports (by having the Commonwealth assume commercial risk). Such mechanisms may be more efficient or economic than EFIC directly providing financing or insurance.

Compliance with international agreements

EFIC has a duty to have regard to Australia's obligations under international agreements.[172] The most relevant agreements for EFIC's operations are the *OECD Arrangement on Officially Supported Export Credits* (the *Arrangement*) and the *WTO Agreement on Subsidies and Countervailing Measures* (the *SCM*), both of which are detailed in Chapter 1.

Market gap mandate

As discussed in Chapter 1, the failure of the private market to provide finance and insurance in support of exporters is a common rationale for the provision of export credit and insurance by governments. It is difficult to say whether inability to deal with the additional risks and information problems associated with financing and insuring exporters accounts for the past dominance of the public sector in export credit markets. An alternative explanation is that an export credit race to provide finance and insurance on less stringent terms than the private sector led to the 'crowding out' of the private market.

The rationale of government intervention in the presence of market failure and a concern not to 'crowd out' the private market are reflected in the legislation for EFIC's original predecessor, EPIC. EPIC was to provide credit insurance to exporters that the private sector would not normally insure.[173] This restriction was included in the *Export Finance and Insurance Corporation Act 1974 (Cth) ('EFIC Act 1974')* that governed EPIC's successor (and the current EFIC's legislative predecessor), the

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[169] ibid, s 8(1).
[170] ibid, s 8(2)(b)(i).
[171] ibid, s 8(2)(b)(ii).
[172] ibid, s 8(2)(b)(iii).
[173] *Export Payments Insurance Corporation Act 1956 (Cth),* s 13.

original EFIC, which was not allowed to enter into contracts of insurance normally insured with commercial insurers[174] and could not finance exports unless EFIC was of the opinion that finance was not available on 'reasonable and suitable terms and conditions'.[175] These conditions were removed from the *EFIC Act 1974* by amending legislation in 1983.[176]

The second reading speech for EFIC's current incarnation under the *EFIC Act* stated that EFIC 'will continue to fill a market gap by providing services which are not normally available from the private sector,' and that 'EFIC will continue to work with the private sector and not in competition with it…'. When EFIC's short-term operations were divested to Atradius in 2003, Ministers agreed that EFIC would continue under its market gap mandate.

The 'market gap' mandate is, therefore, a primary element of EFIC's charter. The existence of the market gap is the reason EFIC exists. Despite the market gap mandate being core to EFIC's operations, it is only detailed in the second reading speech and annually in EFIC's corporate plan. The importance of the market gap mandate warrants an express direction from the Minister, for example in the Minister's Statement of Expectations.

EFIC's fulfilment of its mandate to provide support for Australian exporters and investors in the 'market gap' is central to its role, and the management and board of EFIC's responsibilities in this area will be set out in the Minister's Statement of Expectations. This will provide a stronger authority for the mandate and is an opportunity to clarify Ministerial expectations. The Statement of Expectations should include a statement of principle that EFIC's pricing not undercut the pricing of the private sector when private support is present (for example when syndicating) and not undercut pricing for comparable risks when private support is absent, and, where appropriate, EFIC charge a premium for the additional risk or quality of service it is providing. Each transaction should be assessed for conformity with the market gap mandate.

EFIC's Powers

General powers

EFIC has a general power to do all things 'necessary and convenient to be done' for the performance of its functions.[177] In addition, EFIC has a number of specific powers that relate to the core finance and insurance activities identified in Chapters 2 and 3. These powers are typically constrained by a requirement that exports that receive finance or insurance are identifiably Australian in some manner – an Australian content requirement.

[174] *Export Finance and Insurance Corporation Act 1974 (Cth)*, ss 13(2) and 14(2).
[175] ibid, ss 40(2).
[176] *Export Finance and Insurance Corporation Amendment Act 1983 (Cth)*, ss 4, 5, 9.
[177] *Export Finance and Insurance Corporation Act 1991 (Cth)*, ss 11(1).

Loans

EFIC can finance all or part of an eligible export transaction.[178] An eligible export transaction is related to the export of capital goods manufactured wholly or substantially in Australia.[179] The transaction can be the export, manufacture, installation, operation, maintenance, repair or services related to the export of such capital goods, or related services provided overseas.

Loan guarantees

EFIC may guarantee financiers that lend to businesses in Australia to finance Australian export trade.[180] Australian export trade includes any transaction involving a benefit flowing directly or indirectly from overseas to a person carrying on business in Australia.[181] This encompasses, for example, the guarantees provided to banks under EFIC's Headway product discussed in Chapter 3. EFIC is also empowered to pay fees to the financier for arranging the loan.[182]

Short-and medium-term credit insurance

EFIC may enter into export payment insurance contracts[183] which are defined as insurance against the risk of direct or indirect loss from a failure to receive payment from an act or transaction in the course of Australian export trade.[184] The insurance must be with or for the benefit of persons carrying on business or other activities in Australia. Essentially, this definition describes payments insurance discussed under 'Short-term credit insurance' and 'Medium to long-term credit insurance' in Chapters 2 and 3. After the divestment of its short-term credit insurance business, EFIC was directed by the Minister for Trade not to provide short-term credit insurance on its commercial account.

EFIC has a specific power to provide credit insurance to financiers (discussed as export finance guarantees in the 'Medium to long-term credit insurance' sections of chapters 2 and 3).[185] The Australian content requirement is that the finance must be for an export contract (or a contract for the export of goods or services that has an associated export contract). An export contract is defined as being for the export of goods manufactured wholly or in part in Australia, or for the rendering of services to a person outside Australia.[186] EFIC is also empowered to pay fees to the financier for arranging the loan.[187]

EFIC can also provide payments insurance for co-lenders that it arranges for loans it makes.[188]

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[178] ibid, s 23.
[179] ibid, s 3(3).
[180] ibid, s 16(1).
[181] ibid, s 3(5).
[182] ibid, s 16(2).
[183] ibid, s 14(1).
[184] ibid, s 14(2).
[185] ibid, s 17(1).
[186] ibid, s 3.
[187] ibid, s 17(2).
[188] ibid, s 18.

Political risk insurance

As discussed in chapter 2, political risk insurance (PRI) covers political events defined by contracts. EFIC is able to declare specified causes of losses to be approved causes of loss[189] and insure an Australian business against losses arising from those causes.[190] The Australian content requirement for this transaction is that the person insured proposes or has entered into an overseas investment transaction. An overseas investment transaction can be the acquisition of an equity interest in an overseas company or partnership, the lending of money overseas, or the transfer of money or equipment offshore.[191]

Reinsurance

EFIC can act as a reinsurer (i.e. providing insurance to primary insurers) that provides comparable insurance to that detailed above, including:

- payments insurance for goods exported under an export contract, goods that incorporate goods exported under an export contract and services rendered under an export contract, up to the value of those goods or services;[192]
- export finance guarantees up to the contracted value of the export contract that is required to meet EFIC's Australian content requirement;[193] and
- performance or tender bonds that meet EFIC's Australian content requirement.[194]

EFIC has a broad power to enter into any contract to reduce or reschedule its own loans, insurance and guarantees.[195] This includes reinsurance, guarantees and security arrangements.[196] There is no Australian content restriction on EFIC's power to reinsure its own insurance.

Bonds

EFIC can guarantee or indemnify an exporter for a tender or the performance of a contract,[197] that is, EFIC can provide performance bonds and bonds for tender. The Australian content requirement for these bonds is that the contract be an export contract, at least in part an eligible export transaction or a contract associated with such a transaction.

[189] ibid, s 21.
[190] ibid, s 22.
[191] ibid, s 3.
[192] ibid, s 20(2)(a).
[193] ibid, s 20(2)(b).
[194] ibid, s 20(2)(c).
[195] ibid, s 15(2).
[196] ibid, s 15(1).
[197] ibid, s 19.

Australian content requirement

As discussed above under 'Corporate governance', several of EFIC's functions are defined by reference to Australian export trade or encouraging the financing of export contracts or eligible export transactions and EFIC has a duty to perform these functions in a manner that will best assist the development of Australian export trade. These references in EFIC's functions and duties are supplemented by the specific Australian content requirements associated with each of EFIC's powers. The Australian content requirement associated with each of EFIC's powers is summarised in the table below.

Table 4.1: Australian content requirements

Category from chapters 2 and 3	Product	Australian Content Requirement (ACR)	Definition of ACR
Loan	Loan	Eligible export transaction	Export, manufacture, installation, operations, maintenance, repair or services related to the export of capital goods manufactured wholly or substantially in Australia
Loan and working capital	Guarantee	Australian export trade	Includes any transaction involving a benefit flowing directly or indirectly from overseas to a person carrying on business in Australia
Short and medium term credit insurance	Payments insurance	Australian export trade	Includes any transaction involving a benefit flowing directly or indirectly from overseas to a person carrying on business in Australia
	Export finance guarantees	Export contract or associated contract	Export of goods manufactured wholly or in part in Australia, or the rendering of services to a person outside Australia
Political risk insurance	Investment insurance	Overseas investment transaction	Acquisition of an equity interest in an overseas company or partnership, lending of money overseas or transfer of money or equipment offshore by an Australian business
Reinsurance	Payments insurance reinsurance	Export contract or goods incorporating goods exported under an export contract	Export of goods manufactured wholly or in part in Australia, or the rendering of services to a person outside Australia
	Export finance guarantees	Export contract or associated contract	Export of goods manufactured wholly or in part in Australia, or the rendering of services to a person outside Australia
	Performance or tender bonds	Export contract or associated contract Eligible export transaction or associated contract	Export of goods manufactured wholly or in part in Australia, or the rendering of services to a person outside Australia Export, manufacture, installation, operations, maintenance, repair or services related to the export of capital goods manufactured wholly or substantially in Australia
Bonds	Performance or tender bonds	Export contract or associated contract Eligible export transaction or associated contract	Export of goods manufactured wholly or in part in Australia, or the rendering of services to a person outside Australia Export, manufacture, installation, operations, maintenance, repair or services related to the export of capital goods manufactured wholly or substantially in Australia

During the review, EFIC proposed the need for financial services to SMEs to be enhanced. EFIC felt that there was difficulty for Australian SMEs seeking access to overseas bank financing without local credit history or security. It argued that Australian banks may have SME client knowledge and security but lack the institutional infrastructure to provide offshore funding for an SME and have no commercial pressure or incentive to develop that infrastructure. On the other hand, for overseas banks, Australian SMEs have limited short term revenue potential and financial attraction and the performance and assets of an SME's Australian operations may be difficult to assess from offshore or may be insufficient to access credit.

Consultations with exporters and industry groups highlighted that ways of exporting had moved away from the industrial 'produce and ship' model; they now increasingly involved expansion of supply and distribution chains overseas to source lower priced inputs and penetrate new markets. In particular, some pointed to the inappropriateness of the 60 per cent level of Australian content and the way EFIC applies relevant rules of origin in the new global environment.

While the proposal would broaden EFIC's powers away from traditional powers to support export transactions to powers to support exporters at an operational level, the proposal can reduce the complexity of EFIC's operations. EFIC has existing powers to provide working capital for exporters and to insure overseas investment transactions, but it does not have a specific power to guarantee or finance the inputs to a supply chain. A review of the above table indicates a level of complexity that can complicate EFIC's dealings with clients. Simplification would improve the consistency of the Australian content requirement associated with each power and would reduce the administrative burden on exporters seeking support.

Overall, there is merit in simplifying the powers and associated Australian content requirements detailed in Part 4 of the *EFIC Act*. This would take account of the changed character of financial markets since the *EFIC Act* was first drafted in the early 1990s. This proposal would effectively require a change from an Australian content test to a national benefits test, which would be concerned more with which firm produces an exported good rather than where it is made. It should be noted that several ECAs (e.g., Belgium, Italy and Canada) are moving to looser definitions of national benefit or content for providing support. An amendment to the *EFIC Act* to enhance its powers can be seen as an appropriate response to globalisation and new ways of doing business internationally to the benefit of SMEs. The expansion of powers does not alter EFIC's responsibility to operate only in the market gap, so that provision of these services by the private sector is not crowded out.

On 2 May 2007, the Minister for Trade announced a simplification and expansion of the powers and associated content requirements listed above which will allow EFIC to help Australia's SMEs to establish global supply and distribution chains. This will complement EFIC's current SME programs, such as EFIC Headway.

National Interest Account

EFIC can refer applications for insurance, guarantees or loans to the Minister.[198] The Minister may approve if 'satisfied that it is in the national interest'.[199] The national interest is not defined in the *EFIC Act* and is not formalised in any direction or documentation.

In contrast to its other commercial operations (see above under 'Commercial responsibility), the Australian Government bears responsibility for the commercial outcomes of the transactions undertaken by EFIC in the national interest. EFIC maintains separate accounts for receipts and disbursements relating to liabilities borne by the Commonwealth.[200] EFIC pays the Commonwealth the receipts (interest and premiums) for these transactions.[201] If EFIC is required to discharge a liability for an NIA transaction, the Commonwealth pays the necessary amount and all costs involved.[202] EFIC is entitled to deducted administrative costs expenses related to loans and insurance on the NIA.[203]

The Minister may give EFIC written directions regarding the circumstances in which applications are, or are not to be, referred to the Minister.[204] EFIC must comply with these directions.

EFIC's Role in the Market Gap

EFIC's adherence to the market gap is a key component of its mandate to assist Australian exporters. The term, market gap, is necessarily elastic and ambiguous.

Evidence suggests that for particular export finance and insurance activities, at a given time, the private sector may find the risks impossible to assess or manage profitably. The market gap fluctuates with the level of liquidity and credit risk in finance markets, and changes over time as banks and financiers develop more sophisticated financing or insurance techniques, or gain greater comfort with particular classes and durations of transactions. Additionally, private market appetite varies according to the particular characteristics and underlying commerciality of the transaction in question

EFIC's Performance Since 2003

As discussed in Chapters 2 and 3, private sector capacity in the medium to long-term export finance business has increased significantly. This is partly due to a gradual structural increase and partly cyclical due to very liquid credit markets. While there is a long-term trend toward greater private market capacity, the market gap is also subject to cyclical changes. The time of the last review in 2003 was during a period of relatively tight liquidity in domestic and international financial markets. At the time

[198] ibid, s 25(1).
[199] ibid, s 27.
[200] ibid, ss 65(3), 66(3).
[201] ibid, ss 65(4), 66(4).
[202] ibid, s 65(6), 66(6).
[203] ibid, s 65(10), 66(10).
[204] ibid, s 26.

of the 2003 EFIC Review it was determined that capacity for markets such as PRI had decreased significantly and consequently the market gap for ECA's to service had increased. This was reflected in EFIC's relatively high levels of medium to long-term signings from 2001 to 2003.

Since 2003 the market liquidity situation has changed considerably. As detailed in Chapters 2 and 3 we are now in a period of very high market liquidity which has seen risk premiums fall considerably. Due to this, the market gap has contracted. Consistent with the contraction in the market gap, EFIC's new signings declined significantly in 2004 and 2005 with some pick-up in 2006.

Table 5.1: New Medium to Long-Term Export Finance Signings by EFIC 1996-2006 (excluding Aid loans) (A$ million)

Year	Commercial	NIA	Total
1996	164	0	164
1997	250	0	250
1998	225	70	295
1999	218	12	230
2000	230	5	235
2001	368	3	371
2002	448	7	454
2003	417	56	473
2004	91	5	96
2005	112	4	116
2006	265	5	270

Source: EFIC Annual Reports 1996-2006

EFIC's pattern of new signings since 2003 is consistent with its business focusing on the market gap. Around A$890 million in new business has been written on EFIC's Commercial Account from 2003 to 2006. Of this figure, around 60 per cent are export finance guarantees (EFGs), a product exclusively provided by export credit agencies (ECAs) (refer to discussion of 'Medium to long-term credit insurance' in Chapters 2 and 3). EFGs provide a guarantee to a bank financing a loan to the buyer of the product being exported. EFGs have been adopted by ECAs to move away from direct lending and increase the capacity of banks to undertake longer term transactions and deal with higher risk countries.

EFIC's EFGs are predominantly in the shipping sector which, as per analysis in Chapters 2 and 3 is a significant 'market gap industry' due to its long term and mobile asset with uncertain future values. Consultations with ship builders and banks underline the importance with which EFIC's role in supporting exports in this industry is viewed. EFIC's EFGs that are outside the shipping sector are almost exclusively in high risk countries.

Most of EFIC's remaining new business has been in political risk insurance (PRI) (around 16 per cent of new signings) and bonds, mainly performance bonds (around 16 per cent). As discussed in chapter 2, medium to long-term PRI is a key market gap sector and is considered to be largely the province of ECAs.

The picture with performance bonds is more mixed. Close to half of the new bonds written are to developed countries. It is not immediately apparent how these bonds would fit a market gap profile. As discussed in Chapter 3, however, EFIC can supplement the capacity of the private market by providing unsecured bonds. Several stakeholders consulted during the review suggested that EFIC's role in these transactions has been expanding capacity for exporters that have reached the limits of their available security for bonding facilities with banks or insurers.

EFIC aims to operate in the market gap and devotes significant resources to investigating an exporter's capacity to perform relative to private sector institutions. Banks and insurance companies usually require security which restricts their ability in some cases to provide bonding. EFIC is also willing to provide bonds beyond five years whereas private suppliers usually restrict bonds to five-year terms.

Nevertheless, private market insurers are also able to provide unsecured bonds to supplement existing private market capacity. EFIC must be careful when operating in the bonding market only to play a supplemental role and to operate strictly within the market gap. This can be contrasted with its role in the markets for political risk insurance and export finance guarantees where its participation can encourage the participation of other private market participants.

While there is no strong evidence that EFIC is consistently extending beyond the market gap in the performance bond market, EFIC must ensure that it does not encroach on the capacity of private sector insurers to also play a supplemental role in the private market for bonds.

EFIC's signings in the period 2003 to 2006 can be broken down by risk rating. Generally the risk rating can be a strong (although not necessary or sufficient) indicator of whether transactions are in the market gap. Over 50 per cent of EFIC's signings in 2003 to 2006 are in risk category 4 to 7 countries, particularly Sri Lanka (Risk Rating (RR) 5), Turkey (RR 5), Laos (RR7), Mozambique (RR7) and Solomon Islands (RR7).

There are a considerable proportion of transactions to high income OECD economies which carry a 0 risk rating. Ostensibly it is difficult to see how these would fit into the market gap as it would be expected that the private sector would have sufficient capacity to service exports to developed economies. Nevertheless, as discussed above, certain sectors are difficult for the private sector to service even, to countries with good political risk ratings. This is particularly true of the shipping sector. Of the facilities approved to 0 risk rating economies, around 60 per cent were for the shipping sector. The remaining transactions involve performance bonds and EFGs

A possible scenario of EFIC's operations is that its mere presence in a market 'creates' a market gap. By providing facilities with the advantages of being a government-backed finance and insurance company, it would make it difficult for private sector providers to move into that sector of the market. This market gap creation is a real possibility. EFIC's pattern of signings, though, do not support that this is actually occurring. As can be seen from their signing pattern, EFIC's business freely expands and contracts with cyclical changes in the market gap. If EFIC's

presence was creating a market gap then there would be less evidence of cyclical changes. In this scenario, one would expect EFIC's presence to create a more constant structural market gap.

Even in the bond market, where there is probably the greatest potential for competition, there is no strong evidence of EFIC competing directly with the private sector, providing more of a supplemental role when companies have exhausted available bond lines or private providers cannot extend to the tenors of which EFIC is capable. EFIC's ability to provide bonds at longer tenors does not discourage private sector providers from doing the same as constraints on tenor for private providers arise from other factors such as capital return models and reinsurance availability.

There are also procedural aspects that guard against EFIC creating a market gap. All approved facilities must address in their documentation the market gap issue and how the facility fits in to a market gap. EFIC's practice of pricing at or above market rates (where rates are possible to determine) means there is no barrier for entry for private firms.

Conclusions

Is EFIC operating in the market gap?

EFIC's business since 2003 is consistent with its market gap mandate.

EFIC's export finance business since 2002 and 2003 has decreased, consistent with the erosion of the market gap by the private sector. At present it is not clear whether this will be a consistent trend or is a temporary cyclical reduction. There has been some pick-up in 2006 compared to 2004 and 2005.

There is little evidence that EFIC is competing with private sector providers or expanding out of the market gap in any significant way. There have been no unsolicited complaints received from banks or insurers of EFIC undercutting or competing with them. EFIC maintain their portfolio in the riskier speculative risk rating category (RR4 to RR4.5).

Performance bonds are the key grey area of whether EFIC is entirely within its market gap mandate. One insurer during the consultation claimed that EFIC competed on some performance bond tenders. Private sector insurers are also able to supplement ffacilities providing and EFIC must be careful when operating in the bonding market to only play a supplemental role and to operate strictly within the market gap. This can be contrasted with its role in the markets for political risk insurance and export finance guarantees where its participation can encourage the participation of other private market participants.

EFIC's pricing is generally considered by private market players to be at or above that of private market participants (when present). No interlocutors considered EFIC to be pricing too low.

Should EFIC remain as a government owned statutory corporation?

When discussing the appropriate delivery mechanism for export credits the first question that needs to be addressed is whether any government-supported official export credits are in fact necessary. Results from the review provided in Chapters 2 and 3 still suggest there is a place for officially-supported export credits. While the market gap is currently narrow, it still exists and, according to most parties consulted, is likely always to remain, particularly at the longer term end of the market. There is no evidence that EFIC's abolition would result in private market 'filling the gap.' The private sector is simply unwilling to cover some risks and tenures. A country removing its ECA from this business would therefore risk disadvantaging its exporters. No OECD country is contemplating removing their ECA from the medium to long-term sector of the market. New Zealand, which has relatively low capital good exports, has found it necessary to maintain an agency arrangement to provide medium to long-term export credits.

If it is accepted that a government supported ECA is still required, the question is then which mechanism is most suitable for the Australian case. EFIC's position as an independent agency owned by the state places it in the most common grouping of OECD ECAs. Like all ECAs, EFIC and its operations is reviewed regularly and its operations adjusted. The most drastic of these changes was the divestment of the short-term business in 2003. At that time, EFIC's role as an independent agency to provide medium to long tem export credits was reaffirmed.

EFIC's position as a self-funding independent agency means that, as long as it does not make long-term losses, it is not making a direct call on the taxpayer. Nevertheless, there is an opportunity cost to the money dedicated to EFIC's capital reserves. EFIC is not required to make a rate of return on this capital, but it may be that a more commercial return or more beneficial social use could be made of these resources.

A move, for example, to a private agency arrangement would alleviate the need for this capital to be tied up, as each transaction would be underwritten directly by the government. The first key step of a decision to maintain or divest EFIC then becomes a cost-benefit analysis on what is the best use of the capital resources.

Such a decision would take into account the level of EFIC's signings and exports supported. A continuation of a low level of signings (around $100 million per annum) would make EFIC's operating profitability (separate from its profit on investments) marginal within a few years and make it difficult to justify maintaining the organisation. In this instance a move to an arrangement that did not require such a level of capital resources (whether the COFACE/Atradius or ECGD model) would need to be considered.

Making a confident analysis of trends in EFIC's signings is difficult. While 2004 and 2005 were the lowest signing levels in the past ten years ($91 million and $112 million respectively), the immediately two preceding years were the highest ($448 million in 2002 and $417 million in 2003). This volatility is undoubtedly a factor of the strong cyclical changes in liquidity in the financial markets during this period. It is difficult, though, to determine precisely how much of the downturn is structural and how much is cyclical. EFIC's average signings from 1997 to 1996 were $260 million. The average of the years 2002 to 2005 was around $267 million, close to the long-term average suggesting that the level of signings EFIC could expect is still in the

vicinity of $250 million. This potential average level of signings will be influenced largely by structural factors. An average that falls significantly below this in the period until the next review would suggest that structural shifts had further eroded the market gap requiring EFIC's involvement.

The interplay of cyclical and structural influences on EFIC's signings means that currently, in the high liquidity environment, we are unable to make a judgement on whether EFIC's signing levels will be maintained at a level consistent with long-term viability. Use of the term cyclical for the influence of global market liquidity upon EFIC's signings is not intended to imply a particular pattern to expansions and contractions in global liquidity. The current buoyant liquidity could continue, could soften or a contraction related to unforseen events might occur over the next few years. Forecasting such a trend and its impact on EFIC's level of business on the basis of a few years of signings is an intrinsically speculative task. A clearer assessment of the trend in EFIC's long-term prospects, in the light of further data on its historical performance, will be possible at the next review. The next review could also assess any changes to the *EFIC Act* and their effect on signing levels. These will be key elements in assessing EFIC at that review.

A further review of EFIC with similar terms of reference should be carried out in 2009-10. We would recommend that consideration be given to having appropriate elements of the next review carried out by an independent consultant. The next review should focus particularly on EFIC's status, its objectives, and the appropriateness of current arrangements in fulfilling those objectives. The review will need to take into account the scope, type and volume of work EFIC is undertaking.

As well as addressing the cost-benefit question, detailed knowledge of the pros and cons of other types of arrangements would also need to be understood clearly. While other methods can be simple at a conceptual level, the detail of establishing an appropriate relationship between the government and the delivery provider, or the process of establishing the government as the primary insurer, is complex. For example, as noted above, an agency arrangement with a private company could potentially see the government (and therefore the taxpayer) take on more risk than it currently does with EFIC. As has been seen with the Export Credit Guarantee Department, a move to a departmental approach may restrict support for exporters. Arrangements for participation by relevant experts in multilateral processes such as the Paris Club would also need to be considered.

Prior to, or concurrent with, the next review of EFIC, a thorough research project on alternative arrangements for delivering EFIC's services should be undertaken. The project would need to include the detail of how various arrangements are implemented and explore the legal and financial implications. As well, the rationale of other country's choice of mechanism would need to be explored. The New Zealand mechanism, for example, could be suitable for a country with few capital export transactions. It might be less applicable for a country with significant capital goods exports.

This project would then feed into the next review. This would actively review EFIC taking into account its level of signings since this review and conditions in the market.

A thorough cost benefit analysis of maintaining EFIC compared to other arrangements should also be a key element of a future review.

ANNEX A: TERMS OF REFERENCE

i. Review developments in export finance, insurance and guarantee services since 2003 when the Government last reviewed the Export Finance and Insurance Corporation (EFIC).

- Including an examination of developments in the roles of private sector financial institutions and export credit agencies of other OECD countries and emerging economies.

ii. Review the market gap taking into account the export finance, insurance and guarantee services required by Australian exporters and overseas investors in a competitive global environment and the extent of private sector willingness and capacity to provide those services.

- With particular attention to: small/medium exporters; exporters of Australian capital goods and services; and, markets where the level of risk renders private sector support unlikely.

iii. Consider the implications of (i) and (ii) above for EFIC's operations, and make recommendations where appropriate concerning EFIC's functions and priorities (including possible changes to the EFIC Act)

iv. Consider options for the operation of the National Interest Account, taking account the findings under (i) and (ii) above.

ANNEX B: CONSULTATION SUMMARY

Peak Industry Bodies & Government Departments

Austrade
Australian Business Limited
Australian Electrical and Electronic Manufacturers Association
Australian Trade Commission (Austrade)
Business SA
Department of Industry, Innovation & Regional Development
Department of State Development, Trade and International
Federation of Automotive Products Manufacturers
National Farmers' Federation
OECD Secretariat

Exporters

Alcatel
Almos Systems
Arbortech Industries
Ausenco
Austal
Australian Farmlink
Barclay Mowlem Ltd
Bronx International Australia Pty Ltd
Clarity International
Clough Limited
Codan
Essa Australia
Furnace Engineering
George Weston Foods
GRD
Ground Probe
Hartz International
Incat
Intellection
Leighton Contractors
Lincoln Electric Company (Aust) Pty Ltd
Macarthur Coal
McConnell Dowell Constructors
Moto Goldmines
Multiplex Limited
Nautronix Limited
North West Bay Ships
Oceanis Australia Limited
Oxiana Limited
QED Occtech Services
Q-Mac Electronics
Reefton Mining
Resolute Mining

Runge Limited
Russel Mineral Equipment
Ruth Consolidated Industries (Rural Chemical Industries)
SDS Corporation
Steriline Racing
Tenix Defence Systems
Thales ATM
The Chadwick Group
Webster Ltd
Wintech International
Woodside Petroleum

Financial Institutions

ABN Amro
AIG - London
AIG – New York
AIG (American International Group)
ANZ
Atradius
Atradius – Dutch State Business
Atrium Syndicate (affiliated with Lloyds)
Bank of Queensland
Bank of Tokyo Mitsubishi (Mitsubishi UFS Financial Group)
Berry, Palmer & Lyle (affiliated with Lloyds)
Chaucer Syndicates (Syndicate 1084) (affiliated with Lloyds)
Chubb Pacific Underwriting Management Services Pty Ltd
Coface
Coface – Paris
Commonwealth Bank
Eksport Kredit Fonden
Euler Hermes
Export Credits Guarantee Department (ECGD) - UK
Export Development Canada
Export-Import Bank of the United States
Hannover Re
JP Morgan Chase – New York
Macquarie Bank
Mizuho Financial Group
Multilateral Investment Guarantee Agency
Munich Re
National Australia Bank
Office National du Ducroire
Overseas Private Investment Corporation
Price Waterhouse Coopers - Germany
QBE Insurance Group
RaboBank
St George Bank
Standard & Poors
Standard Chartered Bank

Standard Chartered Bank – London
State Bank of India
Suncorp
Swiss Re
Wellington Syndicate - London (affiliated with Lloyds)
Westpac
XL London Market Syndicate (affiliated with Lloyds)
Zurich Emerging Market Solutions
Zurich EMS – Washington
Zurich Re – London

Submissions Received

Austal (provided in-confidence)
Australian Chamber of Commerce & Industry
Australian Electrical and Electronic Manufacturers' Association
Australian Industry Group
Export Finance & Insurance Corporation (provided in-confidence)
Kai Preugschat
The Chadwick Group
Toolmaking Council of the Engineering Employers Association, SA
Victorian Employers' Chamber of Commerce & Industry