Submission No 1

EFIC
EXPORT FINANCE AND
INSURANCE CORPORATION

Submission to the Joint Standing Committee on Foreign Affairs, Defence and Trade

Inquiry into Australian Relations with Indonesia

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Summary

Australia's exports to Indonesia in the four years ending 30 June 2002 represent about 2.6% of total exports[1].

Over the same period, exports supported by EFIC into Indonesia amounted to about 3.3% of Australia's exports to Indonesia. Globally, EFIC assists about 5% of Australia's exports.

EFIC's short-term credit insurance volumes fell for Indonesia in 1999/00 following the commencement of the Asian economic crisis but have rebounded significantly since that time. During the period, wheat has been the single most insured commodity, initially because the Australian Government established a specific national interest facility to cover the risk.

EFIC's medium to long-term export finance and political risk insurance have not rebounded from highs in the early to mid-1990s when the Australian Government's Development Import Finance Facility (DIFF) funds were available to be used in association with EFIC commercial finance for projects approved by AusAid. A small national interest facility established in the aftermath of the crisis was unused.

Indonesian exposure dominates EFIC's risk portfolio (Commercial and National Interest accounts), representing about 29% of the portfolio. The portfolio is made up mostly of outstanding DIFF-related loans to the Indonesian Government on the National Interest account. The term of the exposure is very long. Payments due since August 1998 under export finance loans to the Indonesian Government have been rescheduled in accordance with three successive agreements with the Paris Club of sovereign creditors to Indonesia. Even if all payments are honoured on schedule and no new exposure is created, the exposure will continue until 2021.

EFIC rates Indonesia 5 (on a six point scale) for both short term and medium/long term risk. Indonesia's rating indicates high risk of insurance claims and loan losses stemming from business cycle and currency volatility, debt restructuring, political instability, and ethnic, religious and separatist unrest. Our rating is generally consistent with that of other rating agencies.

Given the magnitude of our exposure and the level of country risk, EFIC's appetite for new business is modest, but we do have some capacity for sound transactions. Large transactions would be difficult for EFIC to handle. Any support under the National Interest account would be for the Government to decide.

Other financiers are involved in the market although underwriting attitudes are mixed. Our perspective compares favourably with that of others, although our capacity to take risk may be smaller in absolute terms.

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[1] Source: Composition of Trade Australia 2000-01 and ABS.

EFIC assistance to exports and investments

Credit insurance

EFIC has insured about $360 million of exports to Indonesia in the four years to 30 June 2002 representing about 1.5% of our business.

Of the exports insured, wheat (42%), minerals and metals (25%) and manufactured goods (14%) are the principal product groups. The wheat business was initially insured under a National Interest facility. More recently, the trade has been financed by commercial banks with some of the credit risks covered by EFIC under its Commercial account.

Since February 2002, EFIC's short term credit insurance book has been reinsured by our alliance partner Gerling NCM.

Exports Supported – Credit Insurance*

In $ million	1998/99	1999/00	2000/01	2001/02	Total
Commercial Account	32.7	22.3	68.1	124.0	247.1
National Interest Account	39.5	0.0	61.9	9.3	110.8
Indonesia Total	72.2	22.3	130.1	133.4	357.9
Global Total	6,055	5,456	6,234	6,382	24,192
	1.2%	0.4%	2.1%	2.1%	1.5%

*Figures exclude amounts supported under our Export Payment Protection (EPP) policy for which national breakdowns are not available. In any event, EPP amounts are small and assumed to be proportional.

Export Finance

Following the initial impact of the Asian economic crisis, the demand for our export finance services dropped as new project opportunities in Indonesia dried up. Since then, new business has been difficult to conclude. For example, in 1998/99 EFIC managed the availability of a National Interest facility of $10 million to finance small transactions, for which there was considerable interest both on the part of exporters and buyers in Indonesia. No transactions were concluded under that facility.

Indications of EFIC support for new business remained low but recovered by 2001/02 when they reached $218 million. Negotiations supported by these indications have not, as yet, translated into new facilities.

Key Indicators - Export Finance in Indonesia

In $ millions	1998/99	1999/00	2000/01	2001/02	Total
Indications	62	77	107	218	463
Facilities signed	12	20	0.3	0	32.3
Exports Supported*	95	8	12	0	115
Of which					
Commercial account	*32*		*1*		*33*
National Interest account	*63*	*8*	*11*		*82*
Global exports supported	587	507	395	486	1,975
Indonesia share of total	15.8%	1.6%	2.8%	-	4.2%

*In the case of export finance, exports supported are the measure of disbursements made under signed facilities. Exports supported in a given year could include disbursements under facilities signed in previous years.

We have had some success. A significant political risk insurance policy was established in 1999/00 that assisted the insured to establish a position in the market. As its perception of risk changed, the client elected not to renew the policy.

EFIC is presently in discussions on a range of projects, notably in the telecommunications and ships sectors.

Historically, communication (37%) and transportation (29%) sector business figures prominently in the EFIC export finance portfolio in Indonesia. Other important sectors include energy and education. Most of these were aid-related projects under the DIFF scheme.

EFIC's exposure to risk

Exposure to risk – at 30 June 2002

In $ millions	Commercial Account	National Interest Account	Combined
Short-term credit insurance	36.1	4.6	40.7
Medium Long Term	74.2	1,521.3	1595.5
of which			
Loans and loan guarantees	*57.2*	*1,521.3*	*1,578.5*
Political risk insurance	*17.0*	*-*	*17.0*
Total	**110.3**	**1,525.9**	**1,636.2**

At $1.64 billion, exposure to risk in Indonesia accounts for 29% of EFIC's total exposure at 30 June 2002.

The short-term exposure has been revolving and we have not experienced any significant problems during the period.

The medium to long-term National Interest exposure is largely the result of facilities signed under the DIFF scheme that was wound up in 1997/98. Aid grants under the DIFF scheme had the effect of softening the terms of the financing available to Indonesia and was provided by Government through AusAid.

Debt rescheduled under Paris Club auspices

Australia has participated in three rescheduling agreements in relation to Indonesian sovereign debts. Bilateral agreements are negotiated and managed by EFIC. So far, the total amount rescheduled is approximately US$122.6 million and Euro109.4 million (see table below). The agreements provide a grace period of 6 to 8 years with extended repayment terms. The final payment due is June 2021.

Rescheduling No.	Paris Club Agreement	Consolidation period	Amount rescheduled
First	23 Sept 1998	6 Aug 1998 to 31 Mar 2000	US$12.5m Euro28.9m
Second	13 Apr 2000	1 Apr 2000 to 31 Mar 2002	US$27.3m Euro38.6m
Third*	12 Apr 2002	1 Apr 2002 to 31 Dec 2003	US$82.8m Euro41.9m

*Unlike previous agreements, interest payments under the third bilateral were capitalised and rescheduled.

The rescheduling arrangements provided for interest rates to be charged at commercial market rate plus an appropriate margin. As a consequence, there is no interest cost to the Commonwealth or to EFIC, although repayment risk remains. The cost, if any, of future agreements cannot be determined until the terms of the rescheduling are known.

Claims, loan losses and provisions for loan losses

EFIC has paid one small ($45k) short-term insurance claim in Indonesia during the period under review. More significant was a write off amounting to $4.6 million for one of our Commercial Account export finance facilities. At the present time, we have made a specific provision of $1.8 million for another export finance facility.

Indonesian country risk

Rating method

EFIC rates country risk – the probability that a country's political or economic conditions, or both, will hinder the ability of an obligor to meet its contractual obligations.

The particular type of obligor we are concerned with is the trade debtor – we try to measure trade payment risk.

We rate two types of trade payment risk – short-term payment risk (on trade credits with tenors < 1 year) and medium/long term payment risk (tenors 1 year). We try to rate the probability of ultimate loss, not just the probability of a temporary disruption to debt service.

Attachment 1 gives our rating definitions.

Our ratings reflect standard indicators of country creditworthiness, including levels of public and external indebtedness, international liquidity, fiscal and current account balances, inflation, growth and indicators of exchange rate misalignment. We also consider qualitative factors including quality of economic management, degree of law and order, extent of social polarisation and so on.

Indonesia's rating

We rate Indonesia 5 for both short-term and medium/long term risk. Indonesia's rating indicates high risk of insurance claims and loan losses stemming from business cycle and currency volatility, debt restructuring, political instability, and ethnic, religious and separatist unrest.

EFIC's rating is broadly consistent with the ratings of other rating agencies.

Key factors constraining Indonesia's country risk rating include:

- ***Heavy debt burdens.*** Indonesia suffers from two closely related debt problems - a large external debt burden and a large public debt burden. By the end of last year, Indonesia's external debt (public and private) was equivalent to about 90% of GDP, while public sector debt (domestic and external) was equivalent to around 91% of GDP. On either measure, Indonesia is the most indebted economy in Emerging Asia. The large stock of external debt continues to be a source of pressure on both the balance of payments and the exchange rate, while the public sector debt burden remains a serious threat to fiscal solvency. Heavy indebtedness leaves Indonesia exposed to interest rate and exchange rate shocks, and represents a major source of macroeconomic vulnerability.

- ***Fragile external position.*** Indonesia's heavy foreign debt burden means the country remains dependent on official creditors to close large external and fiscal financing gaps. Financial support from the Consultative Group on Indonesia, the Paris Club, and the IMF and World Bank remain critical in allowing Indonesia to meet its external obligations.

- ***Severe structural problems.*** Indonesia's country creditworthiness is also undermined by a series of structural shortcomings. These include a still-weak banking sector, a heavily indebted corporate sector, an ineffective judiciary, weakness in government decision-making and poor corporate governance. Overseas direct investors continue to be discouraged by political, economic and regulatory instability. An additional element of uncertainty has been injected by the decentralisation process, which has allowed regional governments a greater say in taxation and regulation.

This has raised fears among some investors of predatory behaviour by cash-hungry local authorities.

- ***Political and social instability.*** Political instability remains a constraint on Indonesia's market grading despite a marked improvement under the Megawati administration relative to during the Wahid presidency. Megawati's position looks relatively secure at least until presidential elections due in 2004, although as her party controls only 31% of votes in parliament, her government continues to need the support of other parties. As elections draw closer, and political manoeuvring increases, that support may become harder to sustain. Another important political risk factor is that, while separatist and communal tensions have been more successfully contained during the Megawati presidency, they nevertheless remain extremely problematic.

EFIC's underwriting attitude

In spite of the recent payment problems and debt rescheduling in Indonesia we have continued to extend short-term cover. We recommend that exporters seek short, secure payment terms (e.g. cash against documents, documents against payment or letters of credit for periods up to 90 days) particularly for any new buyer. Letters of credit should preferably be from larger more stable banks. We also have some capacity to cover short-term open account risks for those buyers considered by us to be a better risk in the Indonesian context. This usually requires that the buyer operates in an export-oriented industry or has an established track record of dealing with the Australian exporter.

As a result of recent events and our already large medium/long-term exposure, EFIC's appetite for longer-term risk remains extremely limited. Any additional risk of this nature would probably be for only a modest amount and would involve only stronger counterparties (eg a sovereign entity, a major bank or an entity generating foreign revenues sufficient to fully service the debt).

EFIC would have difficulty supporting very large transactions. Any support under the National Interest account would be for the Government to decide.

Attitude of other financiers

The attitude of other national export credit agencies to Indonesian business is mixed. Some agencies limit themselves to underwriting only public sector risk while others will only underwrite selected private sector transactions. In the case of the latter, the obligor typically is able to generate foreign exchange from its operations.

We have observed a slight increase in the activities of banks and financial advisors in Indonesia although activity remains well below pre-crisis levels.

Sectors of particular interest to all financiers include oil and gas, energy and telecommunications.

EFIC's institutional linkages in Indonesia

Over the years, EFIC has developed strong relationships with a range of organisations in Indonesia. Many linkages were strengthened by virtue of the active roll that EFIC took during the Asian crisis and its aftermath. For instance, we have a close and very positive working relationship with the central government by virtue of working with them on trade finance and bilateral debt rescheduling agreements.

EFIC also has established a strong relationship with Indonesia's export credit agency, Bank Ekspor Indonesia (BEI), as a result of our joint participation in a grouping of regional agencies. In addition, we have helped to train key BEI staff in export credit and insurance matters.

Implications of EFIC's withdrawal from short-term credit insurance

In November 2000, the Government announced that EFIC should enter into an alliance with a suitable private insurer in relation to its short-term business. After a public tender process, agreements were signed with Gerling NCM, the second largest global credit insurer. If performance benchmarks are achieved during the alliance period of up to two years, the business will be divested to Gerling NCM.

At the moment, Gerling NCM is reinsuring the EFIC insurance portfolio in Indonesia and we believe that, in the future, it will cover the business that we ourselves would have been prepared to underwrite in the market. In any event, the Government is considering the manner in which short-term credit insurance capacity can be maintained in the event of crisis circumstances once the divestment has been completed. This is likely to be delivered on the National Interest account.

EFIC's ongoing involvement in Indonesia

Indonesia is an important market for EFIC and for Australia more generally. It is imperative for us to be fully engaged in the market and as we proceed we expect to:

- monitor closely the evolution of economic and political risk in the market and making our analysis available to our various audiences as appropriate;
- manage the existing large exposure to Indonesian risk;
- consider any new business, accepting risks as appropriate;
- participate with DFAT in any further Paris Club negotiations and eventually negotiate and manage bilateral agreements on behalf of the Commonwealth;
- visit the market as appropriate when business opportunities arise or to manage the existing portfolio;

- maintain strong institutional relationships with counterparts in Indonesia; and
- we work closely with key allies, notably Australian and international banks, industry associations, Austrade and DFAT.

EXPORT FINANCE AND INSURANCE CORPORATION
OCTOBER 2002

Attachment 1. Rating definitions

Grade	Payment problems . . .	Possible causes . . .	Likely consequences . . .
1	Unlikely	-	-
2	Very minor problems possible, though unlikely	Currency devaluations/depreciations Sharp economic downturns	Rash of bankruptcies Unrecovered claims/loan losses likely to be small
3	Minor problems possible, though unlikely	Currency devaluations/depreciations Sharp economic downturns Exchange transfer delays	Rash of bankruptcies Quick resolution of transfer delays Unrecovered claims/loan losses likely to be small
4	Moderate problems possible (or already occurring)	Currency devaluations/depreciations Sharp economic downturns Exchange transfer delays Banking crises Sovereign debt rescheduling Government payment delays	Rash of bankruptcies Transfer delays could be prolonged, but likely to be cleared Bank claims could be delayed Sovereign debt rescheduling unlikely to involve write-down Unrecovered claims/loan losses likely to be moderate
5	Serious problems likely (or already occurring)	Currency devaluations/depreciations Deep, long recessions Exchange transfer delays Banking crises Sovereign debt rescheduling Government payment delays	Rash of bankruptcies Transfer delays could be indefinitely prolonged Bank claims could suffer indefinite delay/moderate Write-down Sovereign debt rescheduling could involve forgiveness/ write-downs Unrecovered claims and loan losses likely to be moderate
6	Serious problems already occurring	Currency devaluations/depreciations Deep, long recessions Exchange transfer delays Banking crises Sovereign debt rescheduling Government payment delays	Rash of bankruptcies Transfer delays could be indefinitely prolonged Bank claims could suffer significant write-down Sovereign debt rescheduling likely to involve significant forgiveness/write-downs Unrecovered claims and loan losses likely to be large