**Submission of the Department of Foreign Affairs and Trade to the Inquiry into the provisions of the Export Finance and Insurance Corporation Amendment (New Mandate and Other Measures) Bill 2013 by the Senate Foreign Affairs, Defence and Trade Committee**

## Introduction

In September 2011, the Government commissioned the Productivity Commission (PC) to review Australia's export credit arrangements. The *Export Finance and Insurance Corporation Amendment Bill 2013* (the Bill) is the culmination of that review process.

In its response to the PC review in January 2013, the Government agreed that some adjustments should be made to the mandate, powers and governance and financial arrangements of the Export Finance and Insurance Corporation. A number of those changes require amendments to the *Export Finance and Insurance Corporation Act 1991*, which is why this Bill is being introduced.

## The Export Finance and Insurance Corporation

The Export Finance and Insurance Corporation (EFIC) was established by the *Export Finance and Insurance Corporation Act 1991* (the 'EFIC Act') to act as Australia's export credit agency. It is a self-funding statutory authority under the *Commonwealth Authorities and Companies Act 1997* (the 'CAC Act'). EFIC exists to support the growth of Australian businesses internationally. It does this by providing financial solutions, risk management options and professional advice when the private market is unable or unwilling to do so.

EFIC operates in the market gap, where the credit and insurance sectors are not able or are unwilling to provide credit and insurance services to financially viable Australian export transactions or overseas projects. It should not compete with commercial sector providers.

The EFIC Act charges EFIC with four key functions:

- to facilitate and encourage Australian export trade by providing insurance and financial services and products to persons involved directly or indirectly in export trade;
- to encourage banks and other financial institutions in Australia to finance or assist in financing exports;
- to manage the Australian Government's aid-supported mixed credit program; and
- to provide information and advice regarding insurance and financial arrangements to support Australian exporters.

EFIC provides financial support to exporters on one of two accounts: the Commercial Account (CA) and the National Interest Account (NIA). The CA operates on a commercial basis; with EFIC's Board determining whether or not to support particular transactions. The NIA is managed by EFIC on behalf of the Australian

Government. Decisions about transactions on the NIA are made by Government and then managed by EFIC. If EFIC is unwilling or unable to provide support to a proposal on its Commercial Account, it may refer the proposal to the Minister for Trade for possible inclusion on the National Interest Account. The Minister must be satisfied that a transaction is in the national interest before approval can be granted for the transaction to be supported on the NIA. As at 30 June 2012, EFIC had CA exposures of $1.41 billion, the largest proportion (35.4 per cent) of which was to the Australia/Pacific region, and NIA exposures of $692.9 million, the largest proportion (61.3 per cent) of which was to Indonesia.

The EFIC Board currently consists of nine members, including a government member, the Secretary of the Department of Foreign Affairs and Trade. All Board members, apart from the Managing Director, are appointed by the Trade Minister. The Managing Director is appointed by the Board. The majority of members have private sector experience in the finance or related fields. For example, the current Chairman of the Board, Nr Andrew Mohl, is a former CEO of AMP Limited.

EFIC was established in its original form in 1957 as the Export Payments Insurance Corporation, to 'provide Insurance against certain Risks arising out of Trade not normally insured with Commercial Insurers'. The activities and international obligations of export credit agencies (ECAs) in Australia and internationally, as well as the trade financing role of multilateral development banks, have undergone considerable transformation since government export credit arrangements were established. ECAs now offer a wide range of products including bonds, various types of guarantees, political risk insurance and in some cases direct loans. Most OECD member countries, including Australia, are participants in the OECD Arrangement on Officially Supported Export Credits, a framework for the orderly use of officially supported export credits that seeks to foster a level playing field.

**The Productivity Commission Inquiry**

In September 2011, the Government directed the PC to undertake a review of Australia's export arrangements. This was in line with a recommendation from the previous review of EFIC, undertaken by the Department of Foreign Affairs and Trade in 2006, which proposed that EFIC be reviewed by an independent consultant in around four years' time.

*Inquiry terms of reference*

The PC was asked to: review the rationale for government involvement in the provision of export finance, insurance and other financial services; assess the management by EFIC of its functions under the EFIC Act; review EFIC's pricing and service arrangements and assess their impact on incentives for Australian exporters to access private sector providers of export finance and insurance products; and review EFIC's exemption from competitive neutrality policy.

*Consultation process and submissions received*

The PC's review involved a thorough public consultation process. Interested parties and the public had the opportunity to provide written submissions and feedback on an issues paper and a draft report. A total of 116 written submissions were received by the PC, 27 initial submissions and 89 in response to the draft report. Public hearings were held in Sydney, Canberra, and Perth.

Most public submissions were supportive of EFIC's management and role, although some questioned EFICs involvement in large onshore projects. The banks were supportive of EFIC's so-called 'market gap' mandate whereby EFIC constrains its activities to parts of the market in which the private sector is unable or unwilling to operate. They said EFIC was commercial in its price setting and complemented rather than 'crowded out' private sector operators.

In our submission to the inquiry, DFAT noted that most of Australia's trading partners have government supported ECAs and EFIC may help level the playing field for Australian exporters. We said EFIC sits in the middle of the global spectrum of private to fully public ECA institutional arrangements and is conservative in terms of its risk appetite. We made the point that the controls governing EFIC's operations were designed to ensure that EFIC was not competing with the private sector.

In its written submission on the draft PC report, EFIC raised concerns about all but two draft recommendations. EFIC was particularly concerned about the suggestion that it focus on supporting small and medium-sized enterprises (SMEs) while also being required to earn a rate of return comparable to an Australian bank. EFIC argued that such a narrow focus would make it unprofitable. EFIC also opposed the recommendation to stop supporting domestic resource projects and argued that large projects were increasingly reliant on finance from export credit agencies (ECAs) and that EFIC helped to 'crowd in' other ECAs and private investors.

*Final PC Report and its recommendations*

The PC's final Inquiry Report was provided to the Government on 31 May and tabled in Parliament on 26 June 2012.

The PC's report, which focused on EFIC's Commercial Account operations, recommended a significant reorientation of EFIC's Commercial Account mandate to address market failures resulting from inadequate information for SMEs seeking export finance. It argued that the market gap mandate lacked rigour and distorted the allocation of resources within the economy. It said a market failure test was more appropriate. Market gap is a broader concept than market failure as market gap includes transactions that cannot attract private sector support for sound commercial reasons, whereas market failure occurs when transactions that are commercially viable do not take place, or do not take place efficiently, because of inadequate information. The PC argued that Government intervention in export finance markets should be targeted at failures in those markets that impede otherwise commercially viable export transactions and generate a net economic benefit.

The PC found that EFIC did not always price its facilities to fully cover costs. It recommended that EFIC be required to apply competitive neutrality principles (ie, pay fees and charges to remove any net competitive advantage it may have over potential competitors) and the Minister's Statement of Expectations require EFIC to price its facilities to cover the full cost of provision and to earn an appropriately benchmarked rate of return. The PC recommended EFIC restrict its products to guarantees and bonds, only provide support for transactions based on an export contract and cease support for domestic resource projects, related infrastructure and suppliers of goods and services to those projects. There were also a number of recommendations around transparency and governance, including the removal of the government member from the EFIC Board.

*Development of the Government's response*

In the second half of 2012, DFAT chaired an inter-departmental committee process (IDC) to formulate a whole-of-government response to the PC's report. Central agencies (Treasury, Finance and Prime Minister and Cabinet) participated in the process along with others including the Department of Industry and Innovation, the Department of Resources, Energy and Tourism, the Department of Infrastructure and Transport, the Department of Regional Development, Austrade, and the Department of Defence. EFIC was invited to participate in several IDC meetings to provide a commercial perspective and to ensure the Government response would be workable for EFIC. The committee also took into account views of industry when considering the PC's recommendations.

The Government response (Australian Government Response to the Productivity Commission Review Australia's Export Credit Arrangements - Australian Government Department of Foreign Affairs and Trade) agrees or agrees in part with 16 of the PC's recommendations and notes the remaining six. The Government's response to the PC Review introduces an overarching market failure test for EFIC's Commercial Account operations, which is broadly consistent with the PC's key finding that the only potential rationale for government involvement in export finance through EFIC is information-related market failure. The Government response is intended to reorient EFICs operations on the Commercial Account towards supporting commercially viable export-focused SMEs seeking to access export finance.

The response allows for EFIC to continue to provide a full range of products (guarantees, insurance, reinsurance, bonds and loans) according to the existing eligibility criteria in the EFIC Act. It does not preclude EFIC from supporting non-SMEs, provided a market failure can be clearly demonstrated and stricter reporting requirements are met. It agrees to apply competitive neutrality disciplines to EFIC through a tax-equivalent payment and a debt neutrality charge. It also allows EFIC to continue to provide support to firms/SMEs in the domestic supply chain for export-focused projects provided they are 'integral to' export contracts and that the market failure criteria are satisfied. EFIC's guarantee powers are to be expanded to allow it to support offshore subsidiaries of Australian business seeking to establish or participate in global supply chains subject to a 'no net job loss' test and demonstrated support for Australian export trade.

**The Bill**

The Bill implements those parts of the Government's response to the PC Review of Australia's Export Credit Arrangements that require legislative amendments to bring them into effect. These are summarised below.

This Bill will introduce a new mandate for EFIC under Item 7. This will only allow EFIC to provide insurance and other financial services or products on its Commercial

Account where a market failure exists, making it unlikely the products or services would be provided by the private sector. Furthermore, Item 13 of the Bill will require EFIC to focus on providing its products and services to SMEs. The Bill does not limit EFIC to supporting SMEs only, but rather obliges EFIC to focus more of its resources on SMEs.

The term 'market failure' will be defined through a legislative instrument. This will allow the definition to be adjusted if necessary over time to respond to changing international financial practices and market characteristics.

SMEs will be defined (under item 6) with reference to legislative instruments to be made by the Minister. The legislative instruments will set thresholds for the revenue value and number of employees to satisfy the SME definition. The thresholds for SMEs can be adjusted to ensure the definition continues over time to capture exporters most likely to face information-related market failures.

Items 22-24 provide that EFIC's activities on the Commercial Account should comply with competitive neutrality arrangements, requiring EFIC to pay a tax-equivalent payment and a debt neutrality charge. This will ensure that EFIC does not have a net competitive advantage over potential competitors. The EFIC Act currently provides for EFIC to pay tax-equivalent payments and a debt neutrality charge 'in respect of short-term insurance', following amendments made to the EFIC Act in 2000. In 2003 the Government determined that there was sufficient capacity in the private market to meet exporters needs and EFIC divested its short-term insurance business and has not offered short-term insurance products since then. Therefore, the introduction of competitive neutrality for EFIC's current operations requires simple amendments to Sections 61A, 62A and 63A to remove the reference to 'short-term insurance'. This will allow the Minister, in consultation with other relevant ministers, to determine an appropriate tax-equivalent payment and debt neutrality charge or guarantee fee for EFIC to pay to achieve competitive neutrality in its current operations. While the PC did not recommend a guarantee fee, we recognised that a guarantee fee is an alternative to a debt neutrality charge and an option the Government may want to exercise if it is simpler or more efficient for EFIC to pay than a debt neutrality charge.

The Government also agreed to recommendation 9.1, to amend the EFIC Act to exclude Australian Public Service personnel from the EFIC Board. Items 14-21 of the Bill remove all references to a government member on the Board of EFIC. The Bill also includes adjustments to the minimum and maximum number of Board members specified under the EFIC Act to ensure that, once the government member is removed from the Board, the overall number of Board members allowed under the EFIC Act remains unchanged.

The Government did not agree to recommendation 10.1(a), for EFIC to cease providing financial services for transactions that are not based on an export contract. However, it did decide in its response to the PC Review to ensure that, where EFIC provides tender guarantees or performance guarantees under section 19 to transactions that are not based on an export contract, they must be 'integral to' an export contract or an eligible export transaction. Currently the EFIC Act only requires that they be 'associated with' an eligible export transaction. Therefore, the amendments at item

12 will allow EFIC to support suppliers in domestic supply chains for major export projects where those suppliers are integral to the export project.

The Government agreed to a limited expansion of EFIC's guarantee powers to allow EFIC to be more flexible in meeting the needs of Australian businesses in global value chains. Therefore, item 9 of the Bill allows EFIC to provide a guarantee to a foreign subsidiary of an SME carrying on business in Australia. Currently, EFIC can only provide support to the Australian based parent company and cannot deal directly with the foreign subsidiary. This limited expansion of powers is further limited by the caveats set out in item 10 of the Bill. Specifically, EFIC's ability to provide a guarantee to a foreign subsidiary is only possible if the SME parent in Australia certifies that the guarantee will not result in a net reduction in the number of employees of the SME in Australia. Furthermore, through the new definition of 'Australian export trade' at item 5, EFIC can only provide a guarantee for a loan to finance an increase in exports, access to new markets or an increase in dividend flows to Australia.