Financial System Inquiry

Submission by Export Finance and Insurance Corporation (EFIC)

March 2014

Export Finance and Insurance Corporation (EFIC) is Australia's Export Credit Agency (ECA). EFIC is mandated by Government to ensure that those Australian companies with viable export and international business opportunities have the finance to succeed in international markets. While the terms of reference for this Inquiry are broad, this submission focuses on EFIC's two main areas of expertise: financing small-to-medium enterprises (SMEs) and financing exports and investments in emerging and frontier markets. The submission also draws upon EFIC's 50 years of experience and its strong relationships with financial institutions in Australia and around the world.

Contents

Summary **3**

Australia's Financial System **4**

Structure 4

Capital allocation by banks 4

Capital allocation by superannuation 6

Capital allocation may be sub-optimal 6

Access to Finance for Small to Medium Enterprises **7**

Why SMEs can find it difficult to access bank finance 7

Business surveys 7

EFIC's experience 8

Financing Trade and Investment in Emerging and Froniter Markets **10**

Export and investment trends 10

Potential financing gaps 10

EFIC's experience 11

The Rising Importance of ECA Financing **12**

Emerging and frontier markets 12

Australia 13

Annex **15**

Background 15

EFIC's solutions: SMEs 16

EFIC's solutions: emerging and frontier markets 18

EFIC's multilateral engagement 20

Summary

The financial system is inefficient

Australia's financial system is dominated by banks and superannuation funds. It is also tightly supervised and regulated. This architecture has provided attractive returns to investors, and security and confidence to deposit holders. However, from a business perspective, it has also resulted in a culture of risk aversion and a bias against lending to SMEs.

An efficient financial system is one that meets the needs of financiers, households and business. In EFIC's experience, small to medium enterprises (SMEs) and businesses of all sizes operating in emerging and frontier markets, cannot consistently access the finance they need to succeed.

- Funding requirements of SMEs — particularly those which are innovative or growing rapidly — do not fit into the standard criteria, or the model-based lending approach adopted by banks, given the small amounts involved and the lack of security and readily available information on borrowers' abilities to perform. Australia's regulatory settings also bias banks against providing credit to SMEs.

- Australian companies looking to take advantage of opportunities in emerging and frontier markets also face financing handicaps. The international focus of Australia's banks is more limited than that of many of Australia's exporters resulting in financing shortfalls. Financial flows into emerging markets also suffer from short-termism; exposing exporters and investors to abrupt and wholesale credit withdrawals when sentiment changes.

Australian SMEs and transactions of scale in emerging and frontier markets are likely to remain undersupplied for finance in the foreseeable future. This reflects a number of factors including: the specialised and ad hoc nature of the financing required; the strong demand for capital elsewhere; the centralised nature of Australia's financial system; and the relatively narrow business models of the major banks.

At the margin, Government can improve the allocative efficiency of capital

As a commercially run Government-owned Export Credit Agency (ECA), EFIC can ensure finance is available for the benefit of exporting SMEs and those companies, both big and small, willing to take risks and expand into emerging and frontier markets. For more than 50 years, EFIC has shown that this can be done profitably and without distorting the broader financial market. While not always best served by private financiers, such companies are important for Australia's future growth, innovation and productivity. Exporting SMEs account for around 10% of total exports by value, while emerging and frontier markets are becoming the driver of the world economy.

Export credit agencies are an important part of the financial architecture

Australia's major trading partners are aggressively using their ECAs to grow export revenues and employment. In 2012, ECAs in the OECD and the major non-OECD economies (China, India, Russia and Brazil) provided around US$300b in medium-long term export finance and insurance. ECAs have the capability to provide long-term financing, with their support tied to the export of goods or services, or to secure long term supply of materials or energy for their domestic industries. In this environment, countries that do not have a strong and active ECA may handicap their exporters.

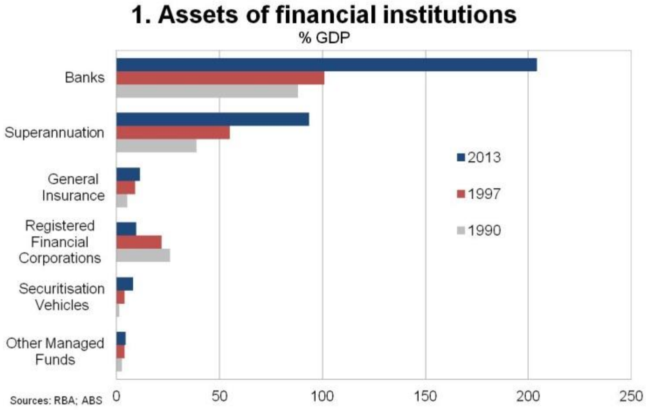
Australia has also been a beneficiary of ECA financing. Since 2009, foreign ECAs have committed around $40b to the development of Australian resource projects and related infrastructure. In some of these projects the amount of finance required — particularly LNG projects — was beyond the capacity of private financiers, particularly at the tenors that more closely match the long life of these assets.

Selectively, EFIC can be catalytic in ‘crowding in’ this vital foreign capital as some providers perceive EFIC’s participation as lowering risk due to: its government ownership; understanding of the Australian legal and environmental framework; and strong bilateral relationships. More importantly, and more frequently, EFIC is able to obtain reinsurance from the private market in transactions in emerging and frontier markets, where those reinsurers would not normally take risk without EFIC’s participation.

Australia’s Financial System

Structure

The Australian financial system has two broad pillars: banks and superannuation funds. These sectors hold 90% of financial sector assets, equivalent to three times Australia’s annual gross domestic product (GDP), with banks holding 60% of assets and the superannuation industry 30% (Chart 1).[1]



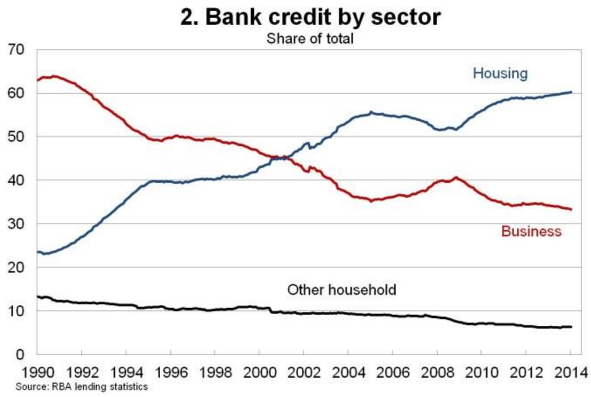
Over time, the financial system has become more concentrated — the share of assets held by banks and superannuation funds has risen from 80% to 90% since 1990. This rising share has been at the expense of Registered Financial Corporations (RFCs) — finance companies and merchant banks — so-called ‘shadow’ banks.

Like banks, RFCs intermediate between lenders and borrowers, but do not accept deposits, and are not regulated by the Australian Prudential Regulation Authority (APRA).[2] Examples include GE Money and Liberty Financial. Their share of assets has fallen from 16% in 1990 to just 3% in 2013, with their decline accelerated by the lack of liquidity in wholesale funding markets during the global financial crisis.[3] While such financiers cover a wide range of business models and add ‘systemic risk’ to the system, they also help fill gaps not covered by other financiers.[4]

Capital allocation by banks

By sector

Australia’s four major banks have very similar business models and hold 80% of banking assets, a very high level of concentration by international standards. In aggregate, these banks have also shifted focus from lending to business to lending to households (Chart 2). In 1990, business loans were 60% of total loans; residential loans 25%. These shares have now reversed: residential mortgages account for 60% of total lending, with business lending approximately 35%. There has also been a



[1] Excludes self managed super. Self-managed superannuation funds have around $500 billion under management and have been growing rapidly; representing around one-third of all superannuation assets. They have been excluded due to their fragmented nature.
[2] These finance companies are required to meet disclosure, licensing and conduct requirements administered by the Australian Securities and Investments Commissions (ASIC).
[3] The other 7% reflects general insurance, securitisation vehicles, and other managed funds.
[4] Financial Stability Board (2012), *Global Shadow Banking Monitoring Report 2012.*

growing trend for loans to smaller businesses to be secured against residential property.[5]

These trends reflect:

1) Relatively stronger demand for credit from households in response to low interest rates, rising incomes, house price gains and low unemployment.
2) Resilience of mortgages in downturns: during the 1990s recession, much higher default rates were recorded on business loans relative to mortgages.[6]
3) Regulatory change: in particular, the introduction of the Basel Capital Accord saw a significant change in risk weightings in favour of housing assets.

Such a high concentration of bank lending going to housing is unique in a global context, with IMF statistics suggesting the total share of lending for housing is more than double comparable countries (Table).[7] Conversely, such a low share of bank lending going to business is surprising, given how dominant the banking sector is within the financial system. Presently, the Australian corporate bond market is only open to large well-rated corporate borrowers, and the shadow banks are small and shrinking.

Lending concentrations

	Residential real estate	Commerical real estate
	% of total loans, end-2012	
Australia	**63.1**	**9.4**
Canada	40.5	2.4
Germany	17.1	5.7
Ireland	30.8	15.0
Italy	18.7	8.5
Korea	22.3	21.9
South Africa	30.3	9.1
UK	16.5	3.3
USA	34.3	15.2

Source: IMF Financial Soundness Indicators

By business

Australia's four major banks currently provide 75% of the total bank lending to business.[8] Foreign banks provide an additional 20% — mainly large corporate loans and project finance.[9] Lending by smaller regional banks, credit unions and building societies is at the fringes, and as a share of the total, has declined since the financial crisis, accounting for around 5% of bank lending.

In Australia, there is no breakdown of lending by size of business borrower. The best available data is lending by size of loans constructed by APRA, with loans less than A$2m assumed to be for SMEs and loans above A$2m assumed to be for medium to large businesses. Based on this measure: 30% of business loans by value go to smaller enterprises; or 10% of total bank lending. Moreover, around 85% of loans are from the four major banks, indicating a low amount of competitive pressure from the second-tier and foreign banks.

The share of bank loans going to Australian SMEs appears low compared to financial systems overseas. It is around that of the US, despite US SMEs being also supplied with finance from the US's large 'shadow' banking system and venture capital market.[10] Compared to other countries where banks dominate, the share is very low. For example, in Switzerland almost 80% of total business loans by value go to SMEs, while Korea (75-85%), Sweden (90%), Norway (50%) and Belgium (65%) also dedicate much larger proportions of business credit to SMEs.[11]

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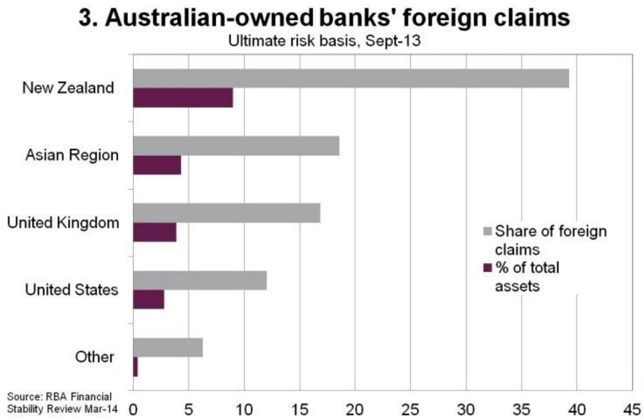
[5] RBA (2011), *Submission into access to finance for small business*.
[6] This in partly reflects the fact that mortgages are full recourse loans giving borrowers an incentive to continue making payments even in times of financial stress.
[7] The figures should be treated as a guide. A significant part of small business lending is secured by mortgage against the family home — so may be captured in the lending to real estate figures.
[8] APRA (2014), *Monthly Banking Statistics January 2014*
[9] Since the global financial crisis the larger European banks have scaled back their operations, but this has been offset by the expansion of Asian banks.
[10] While Australia appears to provide a similar proportion of total bank credit to SMEs, SME loans in the US are those up to US$1m, while Australian figures include those valued up to A$2m.
[11] OECD (2013), *Financing SMEs and Entrepreneurs 2014: An OECD Scoreboard.*

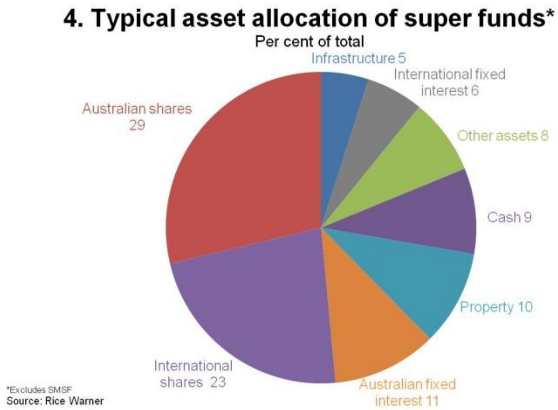
By region

Australian banks are domestically focused. The RBA estimates that foreign exposures represent only 23% of their assets, a smaller proportion than in other comparable banking sectors.[12] To the extent they are offshore, the exposures are concentrated in the UK and New Zealand, where Australian-owned banks operate their main offshore subsidiaries and branches (Chart 3). Australian banks' exposure to Asia has grown over the past six years, from 1.2% of assets to 4.6%, in response to the region's growth and expanding bilateral trade and investment. However, so far the bulk of exposures are in the financial centres Hong Kong, Singapore, and Japan, as well as China. Moreover, 70% of exposures also have maturities of less than 12 months. Overall, exposures to emerging and frontier markets are small.



Capital allocation by superannuation

Australia's superannuation industry is one of the largest in the world: both in an absolute sense and relative to GDP.[13] Strong growth in the sector is expected — more than 60% of Australians have compulsory employer superannuation contributions. The superannuation industry will thus continue to challenge banks as a major player in the receipt and allocation of capital. The investment mix of superannuation funds has been broadly steady (Chart 4). Equities and fixed interest products account for 70% of investments, with the remainder split between property, cash and other assets.[14] Superannuation funds do not lend to business directly. They have also been unwilling to take part in green field domestic infrastructure projects or to support new ventures due to concerns about risk and poor past returns.



Capital allocation may be sub-optimal

To shareholders and investors, the allocation of capital by banks and superannuation funds is rational. Indeed, historically both have provided good returns to investors and security to deposit holders. The financial system was also relatively resilient during the global financial crisis continues to perform well six years later.

However, the allocation of capital may be sub-optimal for promoting economic growth. The small amount of finance allocated to SMEs seems out of step with their 60% contribution to industry-value-added and 70% to employment.[15] This level of financing is also well below comparable countries. The narrow overseas focus of Australia's banks also indicates that Australian companies, both big and small, are likely to suffer financing shortfalls when they try to take advantage of opportunities in emerging and frontier economies — the drivers of world economic growth.

[12] RBA (2012), *International Activities of Australian Banks,* RBA Bulletin December 2012 and RBA (2014), *Financial Stability Review March 2014*.
[13] Towers Watson (2014), *Global Pension Assets Study*.
[14] A notable proportion of these assets will be bank assets. This reflects the major banks' sizable market capitalisation together with the super funds holdings of deposits and bank hybrids.
[15] ABS (2013), *Australian Industry 2011-12,* Cat. 8155

This allocation of capital is unlikely to change for the foreseeable future. The centralised nature of the financial system, current regulatory settings, and the strong returns already available means there is little incentive for financiers to deviate into such riskier types of financing where both the costs of assessing risk and returns from such financing are much less certain. The 'competitive fringe' — in the form of smaller banks, non-bank financial institutions and the capital markets — is also unlikely to challenge the status quo anytime soon due to the limited capital they have to deploy, or are willing to deploy, in Australia. In fact, the financial system has become more concentrated since 1990.

Access to Finance for Small to Medium Enterprises

Why SMEs can find it difficult to access bank finance

Two factors combine to ensure that banks allocate too much finance to other market sectors and too little to SMEs:

- The requirements of SMEs are often not supported by the value of tangible assets as collateral, or the criteria-based lending approach, favoured by banks given the small amounts involved.
- Regulatory requirements set by APRA and the Basel Accords encourage Australian banks to allocate capital to residential mortgage lending rather than business lending.

Collateral and criteria-based lending approach

Banks favour a collateral or criteria-based lending approach. The relationship banking model — where bankers take the time and effort to understand the business and its needs — is less commonly applied to SMEs. This is partly because interest revenues for smaller loans, do not justify the detailed credit risk assessment and relationship management of larger (corporate) loans. Compared to mortgages, of similar size, they are much more difficult to automate and securitise.

This approach does not always suit the requirements of SMEs, as bank support is often limited by the conventional tangible security the SME can provide, even if the company has a track record and technical capacity. This in turn results in allocative inefficiencies where banks lend to businesses with the *best collateral* rather than those with the *best businesses*.

The end result: viable SMEs do not receive all the finance they require, or in the form they require it.

Impact of regulation

Australian regulation requires lenders to hold significantly more capital against SME loans than more 'capital light products' like residential mortgages. This reflects the higher risk profile of SME lending and the larger loss given default, even if the business loan is secured against residential property.[16] As a result, Australian banks have a bias towards residential mortgage lending relative to SME loans in terms of capital management, but also given the extra effort in managing the resultant risks. This is a 'cost' of the stability that regulation provides.

Business surveys

Most surveys of SMEs suggest they find access to finance a hindrance to their growth. In 2011-12, the Australian Bureau of Statistics reported that 16% of businesses found access to additional financing as a barrier to activity; comparable with regulatory issues (15%) and costs of inputs (16%).[17] About 20% of businesses stated that access to finance is the most common barrier to innovation. Similarly, a survey by

[16] RBA 2011: *Submission into the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Access for Small and Medium Business to Finance.*

[17] ABS (2013), *Selected Characteristics of Australian Business 2011-12*. Cat 8167.0. As would be expected, smaller businesses found access to finance a greater barrier.

the Australian Chamber of Commerce and Industry (ACCI) in 2013, found that that 14% of all small businesses and 11% of medium-sized business identified lack of finance as an obstacle to growth. The National Australia Bank SME quarterly business survey suggests credit conditions remain a concern for around 15% of business.[18]

EFIC's experience

Exporting SMEs face access to finance issues

The support EFIC provides Australian SMEs is narrow.

First, EFIC's client base is limited to those SMEs that export, or are in the export supply chain, which is up to 60,000 companies.[19] Second, EFIC can only assist a sub-set of their overall financing needs; that is, working with exporters' banks to ensure that they have sufficient working capital to fulfil export contracts (Annex 1 for details).[20] Consequently, EFIC's exposures to SME exporters are generally less than 12 months duration and are self-liquidating.

Even so, we find that exporting SMEs cannot always access the working capital they require from private financiers. Exporters — particularly fast-growing ones — often have limited additional security available or have been exporting for only a short period. Cross-border trade also has additional risks and is prone to information gaps (such as a lack of information about risk counterparties, inherent political and country risks associated with foreign markets and understanding multiple legal jurisdictions) which increase due diligence time and costs and reduced bank appetite, particularly given the relatively small sums involved.

Surveys of exporters confirm this. A recent survey conducted by East and Partners, on behalf of EFIC, indicated that 28% of SMEs found access to finance a significant barrier to exporting; the second largest barrier after market access issues.[21]

We expect access to finance to become a more binding constraint for the 'next generation' of exporters — hailing from Australia's technically complex and service-related industries. These industries do not benefit from conventional collateral ('bricks and mortar' and inventory) on which banks currently base and determine their appetite for risk. The value-added by these companies and their competitive advantage is intellectual property, something a bank finds difficult to value and therefore lend against.

At the margin, EFIC prudently provides additional support to exporting SMEs because it adopts a capability-focused approach to due diligence, including an assessment of the terms of the contract, to ensure an appropriate allocation of risks between parties. We often rank behind the exporter's bank against tangible security, after being satisfied with the exporter's ability to perform the contract.[22] In doing so, we enable SMEs to demonstrate their capability to perform — signalling to private financiers that these businesses represent an acceptable risk (Annex 1 for case studies).

SMEs can lack understanding of the credit process

Some SMEs struggle to access finance because they lack understanding of the information the lender needs in order to make an informed credit decision. Credit applications often lack basic information such as up-to-date financials and cash flow projections. Disciplines imposed by EFIC to improve the information

[18] It is not the major factor, consistent with the fact that only a proportion of businesses require financing each period.
[19] The definition of a SME varies. EFIC defines an SME as an entity with annual turnover less than A$150m. This definition is modelled on the breakdown employed by trade finance teams in commercial banks. The distribution of EFIC's SME signings is heavily weighted towards the lower end of the turnover scale, with the bulk of SME's supported falling within the A$10-A$60m annual turnover band and with less than 100 employees.
[20] Or pre-shipment finance; this is separate from documentary Letters of Credit which may be required to ensure the exporter receives payment. Letters of Credit are common for trade with emerging markets due to a lack of credit information about buyers.
[21] East & Partners (2014), *EFIC SME Exporter Index.*
[22] Thus helping to mitigate the problem of banks being reluctant to release security.

reported by such clients has enabled private financiers to analyse and assess these risks, resulting in the provision of support for subsequent transactions by banks without the need for EFIC's participation.

SMEs often do not require conventional debt solutions

In many cases, an SME needs 'growth capital' to assist in moving to its next stage of development, such as entering a new market or developing a new product. However, cost and access to (perceived) risky finance is an issue for most.

Transition from development to commercialisation is a risky stage for any business. Until the underlying product or technology has demonstrated some commercial value, banks are reluctant to provide finance. Meanwhile, private equity seeks larger, more developed businesses with strong cash flows and short term exit potential; and venture capital requires board control and new ventures with very high growth prospects.[23] Australia's venture capital market is also in its infancy with investments of just A$120m in 2011 — funding as a share of GDP is well below countries such as the US, Canada, United Kingdom and Israel.[24]

For large companies this 'gap' is often filled by mezzanine finance, but this is not readily available to Australian SMEs.[25] Rather than replacing other forms of finance, mezzanine finance sits between senior debt and equity, with financing reflecting the potential of the firm, in addition to existing cash flows and assets. Consequently, it is more expensive than senior debt, but cheaper than equity (and enables the firm to retain ownership rights and management control).

Overseas schemes to improve access to finance

The global financial crisis exacerbated SME difficulties in accessing finance in many OECD economies. An OECD study found that over 2007-10 SMEs across the OECD faced more severe credit conditions in the form of higher risk premiums, shortened maturities and increased need for collateral to access (or maintain) credit availability.[26] Market conditions have improved since then — though larger and more creditworthy borrowers have dominated access to an overwhelming proportion of this credit.

In response, several OECD countries have introduced or expanded government schemes to improve SME access to finance. This has included: raising overall portfolio capacity; increasing loan guarantee programs; direct financing to bypass banks unable to perform their regular functions; and streamlining existing schemes (Box below). We encourage the Inquiry to evaluate such schemes and determine if they may be applicable to the Australian context.

UK's 'Business Bank'

The UK Government has created a 'Business Bank', which is expected to be fully operational by the second half of 2014, with £1.25b of funding on top of £2.9b of capital from existing state schemes. The Bank's focus will be start-ups and early-stage companies that have difficulty raising finance from commercial banks and investors because they lack a track record. The Bank will work with private financiers and offer a full spectrum of products from debt, to mezzanine financing, to equity. The Business Bank is partly modelled on Germany's KfW — the post-war development bank — which has assets of €476b and lends to Germany's Mittelstand – the network of mid-sized companies that form the backbone of Germany's export-driven economy.

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[23] Venture capital can also be inappropriate if the financing need is temporary.
[24] Cumming, D and Johan. S, (2013), *Venture's Economic Impact in Australia* and OECD (2013), *Entrepreneurship at a Glance 2013*.
[25] Mezzanine finance is a generic term for financing that incorporates elements of debt and equity. It can include subordinated debt and equity warrants and implies a higher risk and reward profile for the financier than 'normal' debt.
[26] OECD (2013), *Financing SMEs and Entrepreneurs 2013*: *An OECD Scoreboard. Final Report.*

Financing Trade and Investment in Emerging and Frontier Markets

Export and investment trends

Fast growing emerging and frontier markets — particularly in Asia — are becoming the dominant focus of Australia's exports and overseas investment. The centre of gravity of the world economy is shifting towards these markets — by 2025 they are predicted to account for over 50% of world GDP.[27] Populations in many of these countries also continue to grow rapidly – in stark contrast to the OECD economies. Moreover, as these economies' per capita incomes rise their relative demand preferences will change, providing an opportunity for Australian services, food, and high-value manufactured goods to complement the already strong supply of Australian resources.

The nature of trade is also changing. To be successful, firms are increasingly looking to establish a local presence to improve market access and product delivery. Consequently, flows of investment are becoming more important in many industries than flows of finished goods. This is particularly the case for Australian firms delivering services (including construction, design, education and health care), or those firms looking to access global supply chains.

These trends are changing the demands on the financial market and resulting in gaps in the level of support that banks can provide for both small and large exporters. Though such transactions can be difficult to finance, these markets are vital for sustainable and broad-based growth of Australian businesses beyond the domestic market. Numerous studies examining firm-level behaviour have found that exporting firms are more productive and innovative than firms that do not export. They also find that exporting firms pay higher wages.[28]

Potential financing gaps

There are three 'financing gaps' Australian business face in emerging and frontier markets.

Australia's banks narrow offshore focus compared to Australia's exporters

Australia has well established export markets for its primary products (such as minerals, fuels, cereals, sugar) and education and tourism services. These sectors account for 70% of Australia's exports and go to a small number of foreign customers, primarily in Asia. The established nature of these export relationships means these exports are well-banked, except in times of financial crisis.[29]

The remaining 30% of Australian exports are much more diffuse by type, transaction size and destination. Australian companies export and hold investments in more than 200 countries — virtually every country in the world; a significant and growing proportion in emerging and frontier markets. Worse, many exports are episodic. For example, exports of capital goods and technical services are generally project-specific, with exporters continually seeking new opportunities in new markets, to sustain their international revenues.

For this 30%, if the transaction is in a developed economy — such as the UK, New Zealand, Euro area, or the US — it is more likely to be well-supplied with private finance. In these markets, Australian-based financiers have appetite as the information gaps and risks around country or buyer risk are lower. Better yet, they are often target markets for Australian banks. Alternatively, the domestic financial markets in these economies usually have capacity for viable transactions.

[27] Conference Board (2014); at market exchange rates.
[28] This likely reflects the fact that more productive firms 'self-select' to export to broaden their markets. Some studies also suggest that exporting itself leads to productivity gains. This could be attributable to greater 'economies of scale' from supplying a larger market than just the home market, or that the competition in global markets compel firms to become more productive — 'learning by exporting' (Girma, Greenaway and Kneller (2002)).
[29] And despite the fact that a significant share of such exports go to emerging markets like China and India.

This is less frequently the case for transactions in many emerging and frontier markets. Here, domestic financiers are immature or non-existent. Meanwhile, Australian or international financiers often have little interest in taking relatively small exposures in distant and non-target markets, especially at the long-tenors often required to make the investment viable for the company and its offshore clients. For Australian banks, the management of such exposures is time-consuming and costly, in turn lowering *net* returns relative to other financing opportunities (particularly if the risk exposure is not spread over a large number of exposures). A lack of readily available information about the nature of the market, the borrowers, and the assets, in combination with weak governance, a lack of familiarity, and untested or unreliable legal systems, can also reduce Australian-based bank appetite to support Australian companies in these markets.

Setting up supply chains

Australian firms, particularly SMEs, which seek to take part in cross-border supply chains and invest overseas, can be hampered by access to finance.[30]

According to a survey conducted by East & Partners, on behalf of EFIC, 60% of SMEs with investments overseas found access to finance as a major barrier to market entry.[31] Sourcing finance from domestic banks in new markets is challenging, as Australian companies are often disadvantaged by their small size, lack of established banking relationships, and a track record.[32] Similarly, Australian banks are often reluctant to support Australian companies in markets where they have little domestic presence given the difficultly in valuing or realising the overseas security.

Large swings in private capital availability

Many emerging and frontier economies are heavily reliant on foreign capital, which can be unreliable in times of financial stress. In fact in some less developed financial markets the availability of private capital can change rapidly, even in response to relatively moderate changes in economic or political conditions. Typically, these markets are frequent users of ECA or multilateral agency finance, given the frequent absence of sufficient liquidity and credit from private banks and bond markets.

1997-98 Asian Financial Crisis

During this time trade finance availability declined considerably, and acceptance and discounting of Asian bank letters of credit came to an almost complete halt given the prevailing uncertainty. Bank-financed short term trade credit fell by 50% in Indonesia and 80% in South Korea. Not only did crisis-afflicted countries find it difficult to import, but Australian exporters had corresponding difficulty in obtaining acceptable payment cover for their export contracts. We responded to this crisis by partnering with the major trade finance institutions in a 50-50 risk-sharing arrangement, which supported Australian exports in excess of $A15b — without credit loss.

EFIC's experience

EFIC provides a range of financial support for Australian companies exporting or investing in emerging and frontier markets (Annex 2). Consistent with our mandate to support viable transactions that are not receiving adequate support from private financiers, our activities extend well outside Australia's 'normal' export financing and trading relationships. In 2012-13 this included financing breeding cattle to Russia, mining equipment into Saudi Arabia, project management services to Afghanistan, and aircraft hangars in the Philippines. A significant proportion of this support was at medium to long tenors.

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[30] This can include: establishing distribution or sales offices overseas; sales offices; new manufacturing plants; commercialising technology; acquiring intellectual property overseas.
[31] East & Partners (2013), *Global Supply Chain. Offshore Operational Investments, June 2013*. This was despite the fact that a significant proportion of such investments were in other developed economies.
[32] This may be compounded by the lack of a domestic bond market for such companies, which means they also have no track record from borrowings on the high-yield bond market.

Overall, the provision of such financial support has been successful for both Australian business and to EFIC's shareholder — the Australian Government. This reflects: our specialist knowledge in country risk assessment; long history operating in these markets; deep relationships with other export credit agencies, multilateral agencies, and other government agencies; and finally a mandate and willingness to take risk. Our success is also shown through our 'crowding in' of private financiers and other ECAs (directly or through reinsurance) to support transactions, that were initially deemed beyond the private sector's tolerance for risk. Overall, EFIC's return on capital has been around 8% (2003-13).

Our support for one large exporter in a challenging market also often helps other Australian companies access that market, through their sub-participation in the resulting 'supply chain'. The size of our financing is contingent on the level of Australian content in the export or investment (Box below).

Lumwana Zambia

In 2006, EFIC provided a loan of US$52.5m and led a syndicate of private insurers to provide political risk insurance cover of US$240m in support of the Lumwana copper mine in Zambia, owned by Australian miner Equinox Minerals Limited. This was the largest foreign investment in Zambia, with the country just emerging from a long period of one-party rule and state nationalisations in the mining sector.

Lack of knowledge about county risk in Zambia resulted in a lack of private finance for the project. To fill this void, base funding was largely provided by multilateral development agencies and ECAs – agencies that specialise in such markets and risks. EFIC's participation not only assisted an Australian-owned company bring the mine to market, it also supported further Australian exports, as the financing was conditional on Australian content in the project. This included a $70m contract to Ausenco Limited for the engineering, procurement and construction contract.

As the mine's performance and operating regime was established, EFIC's facilities were refinanced in March 2010 by commercial lenders on more favourable terms for the borrower. EFIC support not only enabled additional exports through the involvement of Ausenco, but further benefits flowed to Australia through an A$5b increase in shareholder value realised by Equinox when it was acquired by Barrick Gold Corporation of Canada in 2011.

The Rising Importance of ECA Financing

Emerging and frontier markets

Across the developing world, governments are focusing on providing infrastructure to sustain growth and meet the needs of their growing middle classes. According to McKinsey Global Institute nearly US$60 trillion in infrastructure investment is required between now and 2030 to keep pace with projected GDP growth, and around half of this investment will occur in emerging and frontier markets.[33] This infrastructure investment will result in significant opportunities for Australian exporters.

Perhaps more relevant to Australia, the Asian Development Bank estimates that Asia alone needs to invest US$8 trillion in infrastructure over the next decade to sustain growth.[34] In most parts of Asia large investments cannot always be financed in the commercial markets alone. Bond markets remain immature and are not willing to assume construction and ramp-up risks; while banks have constrained balance sheets, exposure limits and regulation that discourages long term exposures.[35] ECAs will partly fill these gaps, either with support tied to the export of goods and services, or as untied support to secure long term supply of materials or energy for their domestic industries.

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[33] McKinsey Global Institute (2013) *Infrastructure Productivity: How to Save $1 trillion per year*

[34] 2010-2020; ADB (2009), *Infrastructure for a Seamless Asia.*

[35] Some regional banks from Australia, China and Japan are becoming more active in financing infrastructure, but most banks lack experience and appetite for project finance. Bond market financing of green field projects is largely nonexistent outside of South Korea and Malaysia.

Australia's major trading partners in Asia, such as China, Japan and Korea, are already aggressively using their ECAs to expand export revenues, increase overseas investment, and boost employment. Signings by China's ECA's and related institutions were estimated to be up to US$70b in 2012 for medium and long term exposures, while signings by South Korea's ECAs increased to US$31b.[36] The growth of this financing not only parallels the expanding economic and trade weight of these economies, but also the use of these institutions by their governments as a tool to pursue broader strategic policy mandates including: energy and food security, aid, infrastructure development and the creation of 'national champions'.

ECA financing is also growing rapidly in other economies. The US Export-Import Bank's (USEXIM) signings have more than doubled over the past five years to $US31b at end-2012, as part of a campaign by the US government to grow export volumes and boost GDP growth. Meanwhile, in 2010, the Brazilian Development Bank (BNDES) disbursed more than three times as much funding as the World Bank – almost half to finance infrastructure.

In this environment, countries that do not promote a strong and active ECA risk potentially place their international businesses at a disadvantage.

Australia

Australia has been a major beneficiary of ECA finance during the recent resource investment boom. Australia was the largest destination for USEXIM support in 2012, and has received multi-billion dollar commitments from agencies in China, Japan, South Korea, Germany and Canada.[37] Since 2009, we estimate that export credit agencies have committed approximately $40b of medium and long-term financing to Australian projects — chiefly LNG, iron ore and coal (and attached infrastructure).[38]

These projects have also been well supported by commercial banks: notably the four major Australian banks, plus banks from Europe and Japan. In most cases, these institutions have contributed up to the limit of their risk appetite. Despite that, ECA financing represents a significant proportion of the debt finance raised. In fact, so important was ECA financing for some of the larger projects that the sponsors often engaged ECAs in the first instance to establish the financing terms and conditions. Commercial lenders only entered the financing arrangements when the structuring and negotiation was largely complete.

EFIC has taken part in few of these major financings, but its role has been catalytic in those that it has supported. EFIC's participation lowers the perceived risk and information gaps in these transaction for other financiers. This reflects EFIC's government ownership, understanding of the Australian legal and environmental framework, and strong long-term relationships with other ECAs (see Annex). This may become an important public good as ECAs from emerging Asian economies play a larger role in not just financing projects globally, but also in Australia.

An example is the US$20b project financing for the Ichthys LNG Project in northern Australia – the largest project financing on record. While EFIC provided only US$150m to the financing, it was appointed to the "pathfinder" group to negotiate terms and conditions, facilitating the participation of seven international export credit agencies now committed to the project's financing. EFIC's facility also helped ensure that Australian companies secured important construction contracts for the offshore works. The loan syndicate included 24 commercial banks and eight ECAs (which provided the bulk of the financing).

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[36] US EXIM (2013), *Report to the US Congress on Export Credit Competition and the Export-Import Bank of the United States.*

[37] Holland, France and Denmark have each committed amounts in excess of US$500m to specific projects in support of their national exporters.

[38] This includes the recent US$7.2b project financing of the Roy Hill iron ore mine — one of the largest land-based project financing deal on record. In this transaction, the total ECA commitment was around US$4.4b.

ECAs are likely to continue to play a role in financing the import of capital goods and projects in Australia, including helping to finance Australia's increasing need for infrastructure. Meanwhile, EFIC has the potential to play a role in easing export infrastructure constraints that are harming Australia's ability to take advantage of rising Asian demand for Australian agricultural products, through financing road, rail, port and airfreight.

Annex

Background

About EFIC

Export Finance Insurance Corporation (EFIC) welcomes the opportunity to make a submission to the Financial System Inquiry. The inquiry is well-timed given the change and, in some respects, the lack of change to Australia's financial architecture since the 1997 Wallis Report.

EFIC is well positioned to provide a submission to the inquiry. EFIC is the Australian Government's Export Credit Agency (ECA) supporting the growth of viable Australian companies in their international activities by providing tailored financial solutions. EFIC's services are provided on a commercial basis and only when the private market is unwilling or unable to provide adequate support.

Evidenced by submissions to the 2012 Productivity Commission report into Australia's export credit arrangements, EFIC does not compete with private market providers of finance and insurance products. Rather, EFIC works closely with private financiers to provide working capital, bonding, buyer finance, project finance, and medium to long-term insurance products. It has been successful in this endeavour, supporting $25b of Australian exports to 65 countries over the past decade.[39] This has been achieved profitably, with $150m in ordinary dividends returned to Government over the same period.

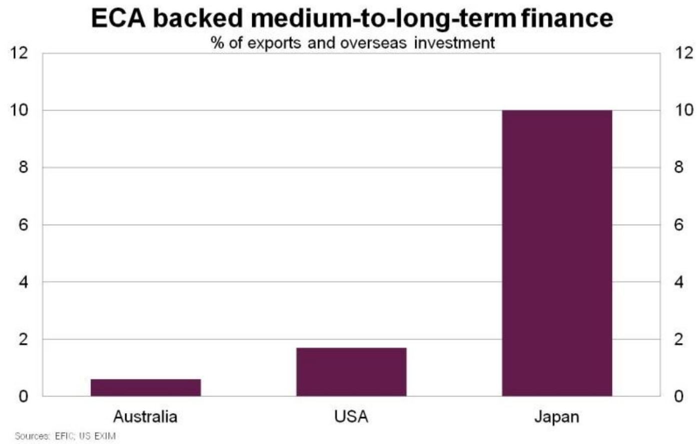
Under its Act, EFIC has three core functions:

1) Facilitate and encourage Australian export trade
2) Encourage banks and other financial institutions to finance exports
3) Provide information and advice on financing and insuring Australian exports

We seek to fill 'gaps' in the provision of financial support for exports and overseas investment. In particular, we are focused on financing exporting SMEs; Australian businesses operating in emerging and frontier markets; and companies involved in new or emerging technologies. These market segments are not comprehensively serviced by Australian banks — in part due to the effort and complexities involved in banking transactions with smaller clients, in challenging markets, or for unique assets or new technologies.

Export Credit Agencies (ECAs)

ECAs are institutions either Government-owned or supported, which provide financial support to expand their national exports. Many countries have a national ECA, including almost all OECD countries. Those that are particularly active include the USA (US Exim Bank); Germany (Euler Hermes and KfW); France (COFACE), the Netherlands (Atradius Dutch State Business); and the UK (UK Export Finance). In the Asia-Pacific region, ECAs represent formidable partners for their respective national companies, enabling them to take advantage of trade opportunities, internationalise their businesses and secure long term supply of energy and resources necessary for their domestic needs. Examples include: China (China Exim Bank and Sinosure); Japan (JBIC and NEXI), Republic of Korea (Korea Exim Bank and K-Sure); Indonesia (Indonesia Exim); India (ECGC and India Exim); Malaysia (Malaysia Exim).



While EFIC's volume of support fluctuates from year to year in response to movements in demand and private market capacity, EFIC's is one of the smallest ECAs in the OECD, and indeed a very modest ECA in relation to the broader ECA community.[40] Nearly all are significantly larger than EFIC, even adjusting for the size of the economy and trade and investment flows. In 2012, EFIC-supported business equated to approximately 0.6% of Australia's total exports and outward direct investment. Meanwhile, medium and long-term support of US ECAs (US EXIM and OPIC) was approximately 1.7% of total exports and overseas investment. Japan's export credit and insurance institutions are thought to have supported around 10% (Chart).

The scope of activities and nature of financial support provided by ECAs is broad. Generally it includes the provision of buyer and supplier credit, pre-shipment finance or working capital, finance to national companies investing offshore (often in addition to insurance services to mitigate payment risks and/or coverage for financial loss arising from political actions (or inactions) taken by the host government where the investment is made). Export support is generally divided into short-term (usually payment terms under two years), medium-term (usually two to five years) and long-term (usually over five years). EFIC has one of the narrowest operating mandates in the OECD.

EFIC's solutions: SMEs

EFIC delivers its financial solutions for exporting SMEs through a variety of products, the most commonly utilised are:

Working Capital Guarantee (EWGG)

Developed and delivered in cooperation with Australia-New Zealand Bank (ANZ), Westpac, Commonwealth Bank of Australia (CBA), Bankwest, HSBC, St George and Standard Chartered Bank, EFIC's EWCG helps Australian exporters source additional working capital to deliver upon an export contract. EFIC provides a guarantee to the exporter's bank, enabling the bank to extend facilities beyond their risk appetite, when further security may be an issue.

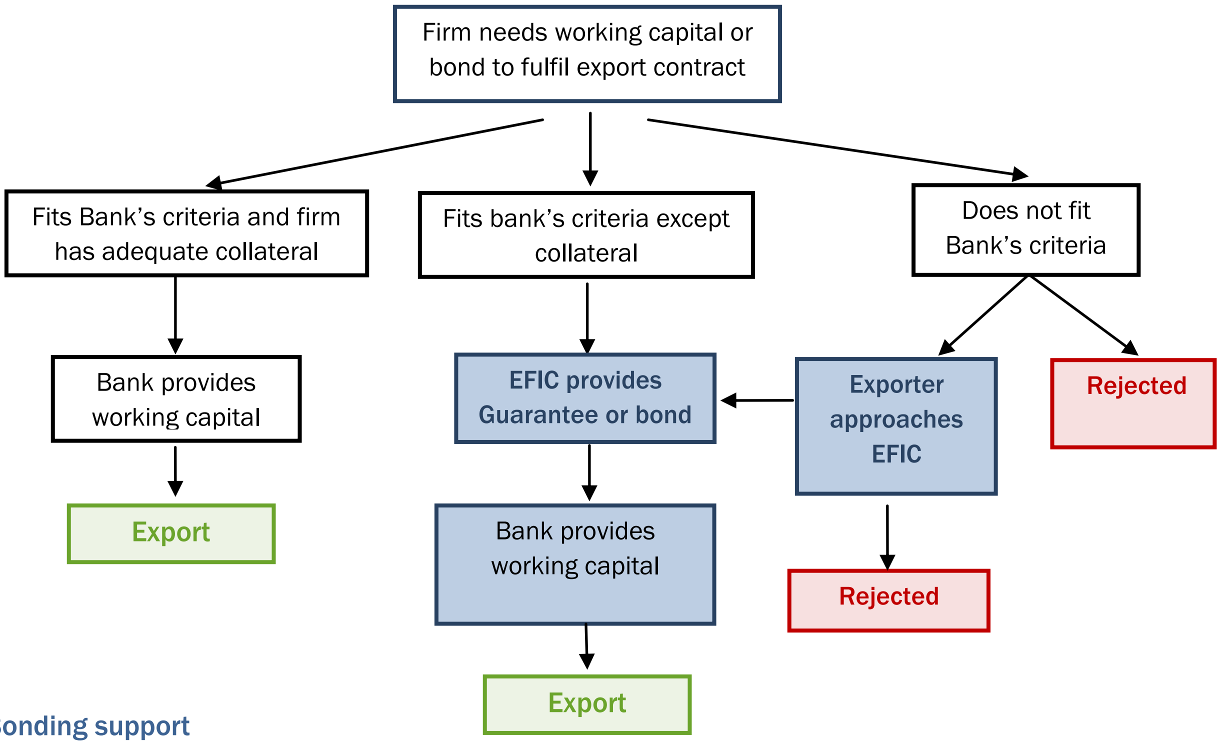
Environmental Systems & Services — Working Capital Guarantee

Environmental Systems & Services Pty Ltd (ES&S), an advanced technology company specialising in solutions in fields such as meteorology, seismology and geotechnical engineering, won a A$2.3m subcontract to provide equipment and training on weather forecasting and meteorological warning solutions in the Independent State of Samoa.

Under the subcontract, ES&S received periodic payments from its customer, however, the lag between when ES&S incurred costs and received payment meant that the company faced a working capital shortage and needed additional funding to perform the contract. To offset this, EFIC provided a six month $500,000 export working capital guarantee to ES&S' bank, enabling the bank to lend the same amount to ES&S to finance the subcontract works.

[40] EFIC has traditionally sat in the same company as smaller European ECAs like Switzerland's SERV and Poland's KUKE. However, since the global financial crisis and the consequent retreat of European private banks, these agencies have increased their level of export finance and insurance support.

Working Capital Guarantee



Bonding support

Bid, performance, retention or advance payment bonds are common in most contracts. SMEs often have difficulty in obtaining sufficient bonding capacity to meet their needs. It is common for SMEs to bid for more work than they expect to win, yet bonding capacity is necessary to enable them to compete for new business, confident that if they are successful, they will have the bonding capacity to enter into the contract. Where that capacity is not available, the SME often has to provide cash in lieu (or an equivalent amount of cash to their bank before the bank will extend further bonds) constraining their working capital. EFIC provides contract specific bonds, or establishes a bonding line, with exporters when their bank cannot meet their total bonding requirements, generally due to a lack of security.

Gasco Pty Ltd — Performance Bond (UAE)

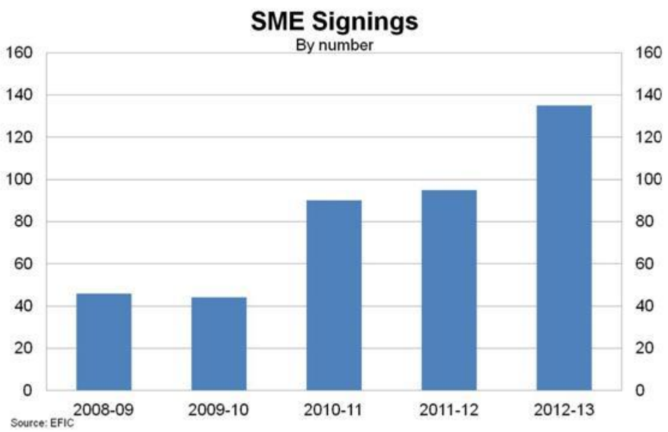
Gasco Pty Ltd, a Melbourne based combustion and process engineering firm, secured a US$6.5m contract to supply equipment to the Dolphin Energy Project in the UAE.

The contract required the installation of two gas-fired heaters for the 240km Taweelah-Fujairah gas pipeline project which involved the production and processing of natural gas from offshore Qatar and transportation of the processed gas by pipeline to the UAE and Oman.

A performance bond was required as a condition of Gasco's contract with the engineering, procurement and construction company, Stroytransgaz, who was building the pipeline. However, Gasco was unable to get the bonding support it needed from its bank alone. EFIC provided a guarantee to Gasco's bank, ANZ, which in turn provided the bond to the buyer enabling Gasco to retain working capital it required to fulfil the contract. It also enabled the company to continue tendering for further contracts throughout the world.

In 2012-13, EFIC provided 160 facilities to SMEs, with SMEs signings now dominating EFIC's portfolio by number of transactions (Chart). However, while the number of transactions is growing, EFIC is only providing its services to a small sub-set of exporting SMEs.

EFIC has had a specific focus on providing working capital solutions to SMEs since 2006 and is continuing to evolve its products and reach to better meet the needs of the disaggregated and disparate SME exporter base. This includes:



- Establishing a team dedicated to expanding the delivery of EFIC's services, including establishing a regional presence of SME origination staff. Over the last 3 years, in addition to its principal office in Sydney, EFIC has established a presence in Melbourne, Perth and Brisbane.
- Reviewing our product offering to better suit the needs of SME exporters. This includes providing supply chain financing for SME subcontractors to export projects; and developing new products such as a Foreign Exchange Facility Guarantee and Producer Offset Loan program to cater for specific financing needs of SMEs.
- Implementing more simplified processes and execution procedures for SME applications.

EFIC solutions: emerging and frontier markets

EFIC provides a number of financing solutions that complement the available private market support, and ensure that viable exports and investments occur in emerging and frontier markets.

Buyer Finance

Success in pursuing export opportunities, particularly in higher risk jurisdictions (or those perceived to be high risk), is sometimes dependent on the availability of finance to the buyer. Lack of a local presence, weak governance environments, and poor quality information regarding foreign buyers and/or their banks, are often deterrents for Australian-based banks to support the exporter by providing finance to the buyer. Moreover, in many developing markets, domestic finance is limited. EFIC meets these buyer finance needs by providing loans directly to the buyer, or guarantees to private banks that are otherwise unwilling to assume these risks. This is traditional ECA business.

Sri Lanka – Buyer Finance

In recent years, EFIC has provided buyer finance to assist a number of innovative Australian companies operating in Sri Lanka.

- Aspen Medical, a Canberra-based SME and 2013 Exporter of the Year Award Winner, is supplying heath care construction services and equipment for a new hospital. Aspen Medical's niche is providing high quality healthcare in challenging environments.
- Outotec Australia, which is developing water treatment plants and an associated transmission and distribution systems to supply clean drinking water to around 0.5m people in east Sri Lanka.
- Wellard Rural Exports, which is exporting dairy cattle, infrastructure, plant & equipment and management services, to help increase the nation's fresh milk supply.
- BP Solar which provided solar-powered drip irrigation systems to 5,000 farmers in Sri Lanka's dry zones.

All of these are examples of the linking Australia's of resources and technical expertise with a country's desire to develop and provide better facilities for its population – the 'win win' that occurs with trade. By working with a range of other financiers (including Australian banks), EFIC ensured that the finance, either through guarantees or direct loans, was available to the buyers so these projects could go ahead. Sri Lanka is a country still dealing with the aftermath of civil war and natural disasters and has weak banks and limited access to foreign capital.

Project Finance

Project finance has been a significant part of EFIC's business over the past two decades. EFIC often works with other ECAs, multilateral financiers and commercial banks to provide the finance necessary to develop projects in emerging and frontier markets. As Australia has become a major exporter of services, in particular those related to engineering for infrastructure and the development of natural resources, the willingness to provide finance for those projects has been a material factor in the success of those contractors in winning business.

Sponsors recognise the potential for contractors to bring ECA finance, and procurement decisions can be driven by the sources of finance available. Consequently, project finance also delivers opportunities for subcontractors and suppliers, many of which are SMEs, to become involved in exporting for the first time, under head contracts with major global engineering firms.

Papua New Guinea – Project Finance

In 2009 EFIC provided a US$350m loan to the Papua New Guinea (PNG) liquefied natural gas (LNG) project — a US$19b project being developed by an international consortium of companies, led by ExxonMobil. The PNG Government is also a substantial shareholder.

The project was unable to raise the necessary finance from private financiers given the widespread funding difficulties in global financial markets and the perception of high country and project risks. Commercial banks provided less than US$2b of the $US14b debt finance required for the project. Instead, the majority of the debt funding was provided by ECAs from the US, Japan, Italy and China and ExxonMobil directly. EFIC's participation was instrumental in 'crowding in' private sector financing due to its past participation in resource projects in PNG and the Australian Government's long history of engagement with the country.

EFIC support also ensured significant Australian content in the project, in the form of Australian civil and mechanical engineering and project management services during construction. Actual Australian content is estimated at over US$1b in contracts; including sub-contracting and owners' costs over US$3b. EFIC participation ensured that Australian procurement was not lost to other countries, as a result of their ECAs requiring higher levels of procurement from their respective countries at the expense of Australian suppliers.

ASX-listed companies Oil Search and Santos are major investors in the project (at 29% and 13.5% respectively) and dividend repatriation by Oil Search and Santos over the 25 year operating life of the project will be substantial. The LNG project will also add considerably to PNG's gross domestic product and provide significant dividends, royalties, jobs and work for local business.

Pre-export Finance

Banks can take a similar approach to providing pre-export finance as they do to providing buyer finance. Further, banks may place little value on the foreign receivable and can be sceptical about the buyer's willingness to pay on delivery of the finished product. In these cases, or where the export order is abnormally large or the exporter has limited financial flexibility, the funds necessary to complete a valuable export contract may be difficult to secure. EFIC provides pre-export finance in such cases. Risk assessment is based on the exporter's ability to perform and the buyer's ability to pay, drawing on EFIC's experience in assessing and managing these risks.

Documentary Credit Guarantees

Non-payment is a significant risk for Australian exporters operating in emerging markets. Exporters will often require that their buyer provide a Letter of Credit issued by the buyer's bank to guarantee payment per the terms of the contract; however, Australian banks are sometimes unwilling or unable to confirm the Letter of Credit because of the perceived risk, a lack of information about the foreign bank, country or counterparty exposure limits. In these circumstances, EFIC can facilitate the release of funds to the exporter by guaranteeing the issuing bank's obligations under the Letter of Credit.

Asian Development Bank (ADB) facility

In 2011, EFIC signed a US$65m risk sharing agreement (later increased to US$90m) with the Asian Development Bank to help extend the commercial banking sector's capacity to support Australian exporters into some of Asia's most challenging markets. The agreement works within the ADB's Trade Finance Program (TFP) which provides guarantees and loans through banks to support trade in Asia.

Many companies in the least-developed economies of Asia struggle to get the trade finance they need to import due to the weak state of their banks. This holds back business and means less job creation and less growth in the developing economies, but also less Australian exports – ADB surveys suggest that without the TFP, bank trade finance support in the 18 countries of operation would fall by at least 13%.

Under the agreement EFIC shares the risk that ADB takes in guaranteeing letters of credit for exports of Australian goods to Bangladesh, Pakistan, Vietnam and Sri Lanka – important future markets for Australian exports. This provides the TFP with additional capacity to support trade in those four countries.

EFIC's multi-lateral engagement

Berne Union

EFIC is an active member of the Berne Union (International Union of Credit and Investment Insurers). The Berne Union is the leading international association for the export credit and investment insurance industry. It works to promote cooperation and stability in cross-border trade by supporting the international acceptance of sound principles in export credits and foreign investment and by providing a forum for exchange among its members in regards to country risks, buyer history, product development and risk appetite. It currently has 48 members whose collective business is over US$1.5 trillion — 10% of the world export trade. The vast majority of members are state backed ECAs and insurers, focused upon the support of national exports and outward investments.

Asian Exim Bank Forum

Formed in 1996, the AEB comprises ten national ECAs with the mandate to offer direct financing. In addition to Australia, membership includes the ECAs of India, Indonesia, Malaysia and Thailand, China, the Philippines, Vietnam, Japan and Korea. ADB is a permanent observer to the Forum. EFIC is active participant at this forum, particularly around the creation of a framework for Reciprocal Risk Participation Agreements (RRPA) between members. With the increase of large-scale projects and trade within the region, the RRPA will be utilised as a basis for ECA cooperation in financing projects or exports which lie beyond the capacity of private lenders or a single ECA.[41]

[41] Overall, EFIC has signed a 14 Reciprocal Reinsurance Agreements with other ECAs.