

Productivity Commission

30 March 2012

Dear Sir/Madam

RE: AUSTRALIA'S EXPORT CREDIT ARRANGEMENTS – PUBLIC INQUIRY

Citibank, N.A. is pleased to make this submission to the Australian Productivity Commission (the “**Commission**”) for the purposes of the Public Inquiry into Australia's Export Credit Arrangements and, in particular, into the Export Finance and Insurance Corporation (“**EFIC**”) and the draft report of the Commission in relation thereto dated February 2012 (the “**Draft Report**”).

1. Citi's Background

By way of brief introduction, Citi is a global financial institution, with branches and subsidiaries in more than 100 countries around the world. We offer a variety of financial products and services, including (but not limited to) capital markets offerings, loans, export credit financing and trade financing, to retail as well as corporate clients. Locally within Australia, Citi is proud to have branches in Melbourne and Sydney servicing our Australian clients (both retail and corporate), many of whom are important Australian exporters.

Citi's status as a global bank means we also interact with the trading counterparts of many Australian exporters, their banks, their competitors, as well as their own regulators, export credit agencies (“**ECAs**”) and governments.

Citi's own Export and Agency Finance (“**EAF**”) team works with more than 65 ECAs all over the world, including EFIC, to promote cross-border trade, investment and development for our clients. In 2011, Citi's EAF team arranged over US\$11.7 billion in Official Agency-supported transactions across 49 countries.

These various factors give us a uniquely global viewpoint.

In the specific context of working with EFIC's product offering, Citi's main experience has been through arranging and funding term loan facilities under EFIC's Buyer's Credit Guarantee.

It is against this background that Citi wishes to respond to the draft findings of the Commission.

1. Summary of Key Themes of the Commission's Draft Report

From Citi's review of the Commission's Draft Report we conclude that most of the Commission's draft findings (and therefore its draft recommendations) result from the following fundamental propositions:

- a) The unfettered workings of the free market should be given absolute priority such that any support given by EFIC should be very limited, so as not to (1) "crowd out" the private sector/market or (2) deliver a financial solution where prudential commercial principle would otherwise result in there being no financial solution being available. It would appear that the Draft Report's findings #3.1, 4.1, 5.1, 6.2 and recommendations #8.3, 8.4 and 10.4 fall into this category.
- b) Small/medium enterprises should be prioritized to benefit from EFIC support (while support given to large Australian exporters should be reduced), (1) because the unfettered workings of the market does not deliver any financing solution to Australian SME exporters, and (2) to avoid unnecessary "large corporate welfare" at Australian taxpayer expense. It would appear that the Draft Report's findings #6.3, 6.4, 7.1 and recommendations #5.2, 10.2 and 10.5 fall into this category.
- c) EFIC's risk taking should be strictly regulated and controlled as if it were a bank or other private sector risk taking institution, and it should price its risk-taking accordingly. It would appear that the Draft Report's findings #6.4, 7.1, 8.2, 8.3, 8.4 and recommendation 8.2 fall into this category.

We believe that such a view is too simplistic and narrow to accurately reflect actual trade patterns, global supply chains with Australian export elements, and financial markets. Nor does it appear to address the real and current financing needs of Australian exporters. We trust that our responses below will illustrate and demonstrate this to the Commission.

2. Citi's Responses to the Commission's Draft Report, Findings and Recommendations

Draft Finding # / Recommendation #	Draft Finding / Recommendation	Citi's Response
3.1	Most products offered by EFIC are also offered by the private sector. The price and conditions of provision may differ.	<p>The key difference between EFIC's offerings and those provided by the private sector, is that EFIC's status as an entity enjoying the full faith and credit of the Australian sovereign government.</p> <p>This gives an immediate credit enhancing effect that private sector providers simply cannot do, no matter how they (or EFIC) price their product. This sovereign risk enhancement enables private sector players rather than crowding them out.</p>
4.1	There can be sound commercial reasons why private providers do not offer some products or do not cover some types of applicants – in which case there is not a market failure.	<p>While it may be commercially sound for private banks, capital markets investors and insurance companies to refuse to offer certain products or provide services to certain applicants, it may not be in the <u>Australian exporters' interests</u> for them to so refuse. This is particularly the case where the Australian exporter is competing for a sales contract in emerging overseas</p>

		<p>markets.</p> <p>It may also be the case that the Australian market is simply incapable of delivering these services/products to exporters in need.</p> <p>For example, an Australian exporter will typically be competing for a contract with a foreign customer with an exporter from another country, who is able to offer longer/better financing terms through the support of their competitor ECA. Globally, across all industries, major RFPs are being awarded to bidders on the basis that their financing proposals are competitive (with ECA-support). Weak support from their home ECA would significantly disadvantage Australian exporter bidders.</p> <p>The Australian exporter's own banks in Australia may also be unable to provide the financing necessary for foreign customers due to lack of a foreign branch/lending office with the necessary KYC, account set-up and credit relationship with the foreign buyer.</p> <p>The foreign customer may be an entity with limited banking relationships (or be located in a market with a nascent financial sector) making it difficult for the Australian exporter to convince international banks (or its own Australian banks) to lend to it without EFIC cover.</p> <p>EFIC is <i>not</i> a bank and it should, as a sovereign ECA, be able to take <i>some</i> risks where commercial banks (due to bank regulatory requirements as well as bank risk/return business models) cannot. In fact, as the Commission's Draft Report points out (in finding # 8.3) EFIC's capital adequacy ratio is currently well <i>above</i> the minimum level specified by Australian Prudential Regulation Authority guidelines, EFIC's internal benchmarks, and which is <i>resulting in an opportunity cost being borne by the Australian taxpayer</i>.</p> <p>Of course this does not mean that EFIC should take imprudent risks on transactions. However, EFIC should certainly play a role in <i>risk sharing</i> with private sector players and helping to bring them into areas where they otherwise cannot go. Providing Buyer's Credit Guarantees to banks lending longer tenors or to borrowers in emerging market countries, where commercial bank lenders or other financial institutions have parallel exposure as part of a larger financing package, or reducing its cover from 100% of a loan to 95% of the loan, are examples of EFIC support which should be encouraged.</p>
6.2	EFIC is likely to be crowding out private sector provision of export finance and insurance.	<p>We see no evidence of EFIC crowding out private sector provision of export finance and insurance. In fact, we have observed the opposite – where EFIC provides its support in a transaction, the private sector players have been able to join the transaction. This actually gives rise to positive competitive forces delivering the best terms to the customer – by having the private players competitively bid against each other for arranging and providing funding under EFIC's guarantee, for instance.</p> <p>Furthermore, in Citi's experience, ECA financing (including financing with EFIC support) can be used either as a "plug" or as an "anchor", where traditional commercial private financing is insufficient. It is never an "alternative" or "competitor" to capital markets or regular syndicated loans, for the simple reason that</p>

		most borrowers globally would much prefer traditional sources of financing for their (1) simplicity and relative speed in execution and (2) ability to leverage relationship banks on financing terms (whilst ECA terms under the OECD Arrangement, as defined below, are non-negotiable).
8.3	<i>The Minister for Trade's Statement of Expectations should require the pricing of EFIC's commercial account transactions to reflect the full economic cost, including a commercial rate of return reflecting risk that is benchmarked against that of appropriately selected private sector providers.</i>	<p>The OECD Arrangement on Export Credits (the "OECD Arrangement"), to which Australia is a party, already provides a highly prescriptive regime for the setting of Minimum ECA Premium Rate (MPR) and minimum fixed interest rates (CIRR) to ensure there is no crowding out of private sector providers by ECAs.</p> <p>This is publicly available on the OECD website, and EFIC (as an OECD ECA) should be already in compliance with these rules.</p> <p>We believe it is best for EFIC to continue to comply with the OECD rules in this regard rather than against some other formula/rules which are inconsistent with the OECD Arrangement.</p>
8.4	<i>EFIC's activity on the commercial account should be subject to competitive neutrality policy. This will require EFIC to earn a rate of return reflecting risk benchmarked against appropriately selected private sector providers, set prices that are commensurate with the level of risk incurred, and pay a tax equivalent charge and a debt neutrality fee.</i>	<p>We believe such measures will be counterproductive because it will actually cause EFIC to be "no different" to a private sector provider, and hence be in direct competition with them, which is an outcome that is opposite to what the Commission is trying to achieve.</p>
6.3	Some financial market participants have a partnership relationship with EFIC, being able to benefit directly from EFIC's involvement in transactions, both through risk transfer and higher returns.	<p>It is incorrect to view the partnership between banks and EFIC as one which gives rise to a "benefit" to such banks. Rather, the EFIC Guarantee product enables these banks to lend in circumstances where they otherwise would not have been able to do so. Indeed, the EFIC Guarantee reduces their risk, but it also reduces their return (the market pricing commanded on a loan asset guaranteed by EFIC is significantly lower than the pricing on the same loan asset without the EFIC Guarantee).</p> <p>The only real beneficiaries of the EFIC Guarantee are:</p> <ol style="list-style-type: none"> 1. The buyer of the goods (who are now able to get bank financing on terms previously unavailable). However, to get this "benefit", the buyer has to pay the EFIC Guarantee Premium; and 2. The Australian exporter, who can now rest assured that their export contract (and hence their buyer's payment obligations to them) is financed and taken care of. The Australian exporter is the only "true" beneficiary in the sense that they have not had to pay anything to EFIC for the issuance of its Guarantee. <p>Lastly, it is actually the private sector institution who provides a "benefit" to EFIC and the Australian exporter on EFIC transactions. Such benefits include:</p> <ol style="list-style-type: none"> 1. Transaction origination, credit risk sharing and due diligence by the private sector financial institution – which (particularly if it is a global institution like Citi) is likely to have far more, and deeper, resources available to fulfill these tasks than either the Australian exporter or EFIC combined; 2. The private sector financial institution can (and typically does) provide ancillary services necessary for the transaction (eg.

		account bank, local security trustee, facility agent, interest rate hedging, FX hedging, etc) that EFIC itself cannot provide.
10.1	<i>EFIC's support for onshore resource projects should cease, as there is no clear market failure affecting access to finance for these projects. The EFIC Act should not be amended to allow EFIC to enter into loans for the export of non-capital goods.</i>	<p>This recommendation seems inconsistent with the primary nature of Australia's export sector. The dominance of the primary sector (in agriculture, mining, gas, and other natural resources) is likely to continue for the foreseeable future.</p> <p>EFIC support for such domestic projects which directly export out of Australia (including non-capital goods such as iron ore, etc) directly promotes and benefits Australian exporters, service providers and Australian businesses and communities that depend on the success of such projects.</p> <p>In our view, in terms of "delivering direct value to the Australian tax payer and Australian economy", such domestic project borrowers have far greater positive impact on the Australian domestic economy than "pure" export transactions where the beneficiary of EFIC-supported financing is located overseas.</p>
10.4	<i>Amendments to the Export Finance and Insurance Corporation Act 1991 should be made to limit the financial products offered by EFIC on the commercial account to guarantees and allow for the product range on the commercial account to include the provision of reinsurance cover for sovereign and country risk insurance provided by the private sector in times of disruption in particular markets.</i>	<p>We believe that such amendments are unnecessary. There is significant room for EFIC to continue to play a role as a direct lender (and in particular, as a lender provider of fixed rate Commercial Interest Reference Rate or "CIRR"), as no other agency or institution in Australia is mandated to do so. There are strict rules already in the OECD Arrangement governing the minimum calculation of CIRR.</p> <p>In the meantime, Australian exporters are competing against exporters in various overseas countries like Sweden, Norway, France, Germany, Japan and others where the CIRR is provided by their own ECA (or affiliated agency/alternate CIRR provider).</p> <p>For regular floating rate loans, there is no reason to suggest that EFIC (acting as a direct lender) would seek to compete with commercial banks in Australia or overseas. In fact, this is precisely the reason why EFIC typically prefers to find a commercial bank to fund under its Buyer's Credit Guarantee.</p>
6.4	There are reasons why there may be no complaints about potential underpricing from EFIC, including its partnerships with other export credit agencies and some private sector providers.	<p>As mentioned above, we do not believe EFIC can under-price its premium or any interest rate on a direct EFIC loan without triggering a breach of the rules contained in the OECD Arrangement. Furthermore, the OECD regularly revisits and reviews its Minimum Premium Rates and incorporates changes in recognition of market trends.</p> <p>As far as we have experienced, EFIC complies with the OECD Arrangement rules on premiums and minimum interest rates, and we have not observed any instances of under-pricing in this regard.</p>
7.1	Not all of EFIC's transactions are priced to earn a commercial rate of return. The expected income from some transactions does not cover their full economic costs, including the cost of capital. These transactions are effectively being subsidized by taxpayers.	See our earlier comments about the minimum ECA premium and interest rate rules contained in the OECD Arrangement, which EFIC already complies with.
5.2	<i>EFIC's definition of a small-to-medium sized enterprise should be limited to firms with annual turnover of less than \$25MM.</i>	<p>We believe that this threshold is completely arbitrary and will detrimentally affect many small and mid-sized Australian companies.</p> <p>From our experience, it is actually in the interests of small companies that <i>all</i> companies (regardless of</p>

		<p>size) be eligible for EFIC's support. This is because most healthy supply chains (particularly those relevant for exports out of Australia) will feature both large and small companies, with many of the smaller players supplying behind their larger counterparts who lead cross-border projects and facing foreign buyers.</p> <p>For instance, Australian EPC and mining contractors tend to be large but they will in turn sub-contract to smaller companies to fulfill their EPC obligations and for ongoing service, re-supply and maintenance requirements. These smaller companies (on their own) simply do not have the international presence to be effectively competing on a global scale for large projects which require large bid-bonds, substantial completion guarantee obligations, etc. In order for these smaller companies to succeed, we also need to support the bid of the larger Australian exporter who is fronting for them, or who is otherwise featured in their supply/value chain.</p> <p>ECAs (including EFIC) have reinsurance arrangements with each other and with private providers (which are already in place) which work in favour of smaller sub-contractors and offers flexibility to larger contractors bidding for large contracts featuring supply from a number of countries. In our view, it is in the interests of small Australian exporters that EFIC should be able to participate in such arrangements in favour of small and large Australian bidders.</p>
10.2	<p><i>Until it is next reviewed, EFIC's role on the commercial account should be limited to demonstrating to the private sector that providing export finance to newly exporting SMEs can be commercially viable. EFIC must demonstrate that this can be done on the same basis as the private sector – with price covering the full economic cost of provision.</i></p>	<p>While EFIC should undoubtedly continue to play a "demonstrative" role to convince private sector players to support newly exporting SMEs, we do not agree with the Commission's proposal to limit EFIC's scope of activity in this way for the reasons already discussed above.</p>
8.2	<p>EFIC's internal auditors found that EFIC has had high exposure to some sectors, notably ship building and operation and some countries.</p>	<p>This is probably due to Australia's export economy being highly concentrated in several specific sectors, and the nature of Australia's export economy is not going to change any time soon. Therefore, in our opinion, the best way for EFIC to manage this sort of concentration risk is to diversify across sub-sectors within each sector (for instance, in ship-building, diversify across passenger ferries, offshore service vessels, etc – all of which are driven by very different demand, price and economic cycles).</p>
8.2	<p><i>EFIC should revise its risk management policies to include a limit on exposures to particular industries.</i></p>	<p>See our comments above.</p>
10.5	<p><i>A limit of three transactions per client should normally apply to EFIC's future operations.</i></p>	<p>We believe that this is not a correct way to control EFIC risk exposure, particularly in the case of Buyer's Credit Guarantees. In this specific product offering, EFIC's client is the Australian exporter, however, EFIC's risk exposure is the overseas buyer.</p> <p>It would be more sensible for EFIC to adopt an exposure limit against specific buyers rather than a per-exporter transaction limit, which would be detrimental in promoting Australian exports.</p>

3. Conclusion

Citi's own experience has shown us that global trading patterns and supply chains feature both large and small companies, and that it is often very beneficial for smaller Australian companies when their larger counterparts receive support from ECAs.

All Australian exporters need and rely on the active support of **both** the private sector (such as insurers, capital market investors and private banks) *and* the public sector entities (such as ECAs).

EFIC's current statutory mandate and product offering (in particular, its Buyers Credit Guarantee) enables it to be a bridge between what private markets and players can deliver and what is actually required by Australian exporters to promote their export activity and compete on a global scale.

We have found EFIC (as well as other ECAs) to be instrumental in delivering private sector finance to borrowers and countries on terms and in amounts which are otherwise not available at all from the private market. This trend has been accelerated in recent years due to several factors:

- (i) The significant structural changes being brought to the Australian and international banking sector by Basel III;
 - (ii) The ongoing Eurozone fiscal crisis resulting in a withdrawal of USD liquidity from non-American lenders (including Australian banks); and
 - (iii) The ongoing recession in most of Europe and Japan, and the weak recovery in Northern America (coupled with the ongoing strength of the Australian dollar),
- all of which result in Australian exporters needing more support than ever from EFIC to promote and sustain their cross-border sales activities.

In Citi's experience, we have found EFIC to be highly professional, commercial and prudential in evaluating transaction risks and setting its risk premiums in accordance with the rules laid out in the OECD Arrangement.

However, we also have observed that EFIC's current per-transaction exposure limit of \$150 million hampers its ability to use its current mandate to its maximum potential (compared to other ECAs globally). This leaves Australian exporters at a significant disadvantage against their competitors globally, especially when one considers that ECAs of other countries can have single-transaction exposures of greater than \$500 million.

Further restrictions as suggested in the Commission's Draft Report (such as limiting the number of transactions per exporter to 3, etc) will only further detriment Australian exporters.

We thank you for the opportunity to respond to the Commission's Draft Report and would be pleased to provide further information if requested.

Yours sincerely

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