

## **EXPORT FINANCE AND INSURANCE CORPORATION AMENDMENT BILL 1999**

### **OUTLINE**

The purpose of this Bill is to amend the *Export Finance and Insurance Corporation Act 1991* to apply aspects of the Commonwealth's competitive neutrality policy to the Export Finance and Insurance Corporation (EFIC). EFIC is a Commonwealth statutory authority charged with supporting Australian exporters by providing a range of insurance and finance facilities where these are not normally provided by the private sector.

The Commonwealth's competitive neutrality policy requires that government business activities do not have net competitive advantages over their private sector competitors simply as a result of their public ownership. Accordingly, this Bill applies a debt neutrality charge, guarantee fee and tax-equivalent payments to EFIC's operations in the area of short-term insurance contracts. The Bill also removes EFIC's current exemptions from the *Insurance (Agents and Brokers) Act 1984* and *Insurance Contracts Act 1984* in relation to such operations.

### **FINANCIAL IMPACT**

The measures contained in this Bill do not involve any expenditure by the Commonwealth. EFIC will be required to make annual payments to the Commonwealth in line with its debt neutrality, guarantee and tax-equivalent obligations. The Minister will be required to make determinations as to the magnitude of these obligations, and it is not possible at this stage to estimate the size of payments which EFIC will be required to make.

**1999**

**THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA**

**HOUSE OF REPRESENTATIVES**

**EXPORT FINANCE AND INSURANCE CORPORATION  
AMENDMENT BILL 1999**

**EXPLANATORY MEMORANDUM**

(Circulated by authority of the Minister for Trade, The Hon Tim Fischer MP)

## NOTES ON CLAUSES

### PART 1 – INTRODUCTION

#### Clause 1 - Short Title

This clause would provide for the Act to be cited as the *Export Finance and Insurance Corporation Amendment Act 1999*.

#### Clause 2 – Commencement

- (1) This subclause would provide for the Act to commence on the day on which it receives the Royal Assent.
- (2) This subclause would provide for Item 4 of Schedule 1 (Tax-equivalent payments) to be deemed to have commenced on 1 July 1998.
- (3) This subclause would provide for Items 2, 3 and 4 of Schedule 2 (amendments to the *Insurance Contracts Act 1984*) to commence on a day to be fixed by Proclamation.
- (4) This subclause would provide for the items referred to in subclause 3 to take effect on 1 July 2000, if Proclamation has not occurred earlier.

#### Clause 3 – Schedule(s)

This clause would provide for the amendment of each Act specified in a schedule to this Bill in the manner specified in the schedule.

### SCHEDULE 1 – AMENDMENT OF THE EXPORT FINANCE AND INSURANCE CORPORATION ACT 1991

#### Item 1

This item would provide for the interpretation of the term *short-term insurance contract* to be an export payments insurance contract under section 14 of the *Export Finance and Insurance Corporation Act 1991* (“the principal Act”) that covers a loss or detriment arising out of a contract or arrangement whose initial payment term is no longer than 360 days, but does not include an export payments insurance contract that the Export Finance and Insurance Corporation (EFIC) has entered into, whether wholly or partly, in accordance with an approval or direction under Part 5 (National Interest provisions) of the principal Act.

#### Item 2

Item 2 would insert a new section 61A into the principal Act as follows:

#### 61A Debt neutrality charge

This new section would provide for the payment of a debt neutrality charge (to apply to borrowings by EFIC), and for the Minister’s determination of the terms and duration of that charge, by EFIC to the Commonwealth in respect of short-term insurance contracts entered

into by EFIC. The purpose of the debt neutrality charge is to ensure that borrowings by EFIC from financial markets are priced on a similar basis to borrowings by a private sector insurer.

### **Item 3**

Item 3 would insert a new section 62A into the principal Act as follows:

#### **62A Guarantee fees**

This new section would provide for the payment of a guarantee fee (to apply to EFIC's use of the Commonwealth guarantee), and for the Minister's determination of the terms and duration of that fee, by EFIC to the Commonwealth in respect of short-term insurance contracts entered into by EFIC. The purpose of the guarantee fee is to address any advantages which the Commonwealth guarantee of its obligations provides EFIC when entering into short-term insurance contracts.

### **Item 4**

Item 4 would insert a new section 63A into the principal Act as follows:

#### **63A Tax-equivalent payments**

This new section would provide for the payment of tax-equivalent amounts by EFIC to the Commonwealth in lieu of the amount of tax which would, but for section 63 of the principal Act, have been payable in respect of short-term insurance contracts. Tax-equivalent payments are to be made in respect of each financial year and are to be determined by the Minister on the basis of ensuring that EFIC does not enjoy a net competitive advantage over other insurers because of the operation of section 63 of the principal Act.

## **SCHEDULE 2 – AMENDMENT OF OTHER ACTS**

### ***Insurance (Agents and Brokers) Act 1984***

#### **Item 1**

This item would amend paragraph 7(c) of the *Insurance (Agents and Brokers) Act 1984* to remove EFIC's current exemption from this Act in relation to short-term insurance contracts (within the meaning of the principal Act), and retains the exemption from this Act for all other EFIC business.

### ***Insurance Contracts Act 1984***

#### **Items 2-4**

These items amend paragraph 9(1)(c) of the *Insurance Contracts Act 1984* and add a new paragraph 9(1)(ca) to this Act to remove EFIC's current exemption from this Act in relation to short-term insurance contracts (within the meaning of the principal Act) entered into on or after the commencement of paragraph 9(1)(ca), and retain the exemption from this Act for all other EFIC business.

## **Regulation Impact Statement (RIS): Application of Competitive Neutrality (CN) to the Export Finance and Insurance Corporation (EFIC)**

### **Background**

EFIC's mission is to increase exports from Australia. It provides a range of short-term credit insurance and guarantee services to exporters as well as medium/long-term finance, guarantee and political risk insurance services to their offshore buyers and financiers. EFIC's operations seek to fill a market gap arising from the inability or unwillingness of the private sector to provide export insurance and other services in particular cases. In addressing this gap EFIC does not seek to compete with the private sector, but as a matter of practical operation, there will be a grey area at the boundary between commercial and non-commercial transactions.

It is important to note that the grey area is confined to short-term credit insurance. Even in countries where governments have withdrawn from short-term insurance for exporters, medium/long-term business is still provided or supported by government.

The EFIC Act provides for EFIC to enter into "national interest" business. This happens where EFIC will not accept a transaction, usually because the risk is too high or the transaction is too large, but the Minister considers it to be in the national interest and directs EFIC to provide the service. An example is credit insurance for Korea, where earlier last year EFIC advised the Minister that it had reached its limit for exposure to Korea, and the Government provided additional capacity to assist exporters during the East Asian financial crisis. Such business is accounted for separately, on what is known as the National Interest Account. Because EFIC, with a market gap charter, has already decided it cannot accept the business on its own account, it is practically certain that no private company would accept the business, so National Interest business is considered non-commercial.

Australian exports amounted to \$114 billion in 1997-98. The overwhelming majority of those exports are financed by the banking sector on the basis of traditional trade finance methods or the risks are self-insured by Australian companies. Roughly \$10 billion is credit insured.

In short-term business, some \$6.6 billion of exports were supported under EFIC's own account and a further \$0.23 billion under the National Interest Account. As such, EFIC accounts for roughly 66% of the export credit insurance purchased by exporters. Australian commercial market insurers include QBE Trade Indemnity, FAI and AIG. In addition, European insurers such as COFACE and NCM also provide cover largely in support of business involving European multinationals with operations in Australia.

In the medium/long-term business, there are no competitors in Australia *per se* because of the inherent risks. Exports supported in this segment of the business amounted to \$400 million in 1997-98.

The implementation of CN in EFIC to date has been limited to separating the short-term business from the medium/long-term business in its accounts, and a decision that EFIC will pay tax on the short-term business from 1 July 1998 onwards.

### **Problem**

CN requires that government business activities do not have a net competitive advantage over their private sector competitors simply as a result of their public ownership. It aims to ensure

that resources available for public expenditure are used in the most efficient manner possible, and to improve transparency and accountability in public sector business.

In respect of EFIC's medium and long-term business and National Interest account business, there is no dispute that all transactions are non-commercial. Consequently the issue of competition with the private sector does not arise and there is no policy imperative to apply CN in these areas. With EFIC's short term business, however, a proportion could be carried out by the private sector on commercial terms. Consequently, issues of possible competition with the private sector may arise.

EFIC's current arrangements do not fully reflect CN policies. In part, this recognises that much of its business is in an area where there are no private sector providers (its competitors are agencies in other countries, which are either owned or supported by their governments) - the problem is to ensure CN applies where EFIC could compete with the private sector, without jeopardising its support for Australian exporters. EFIC's private sector counterparts in Australia limit their business to short term credit insurance and bonds. In common with many of its counterpart agencies in other countries, it has no domestic private competitor for its medium and long term finance and guarantee business.

### **Objectives**

The objectives are to ensure the benefits of CN are realised in EFIC's operations, without jeopardising EFIC's support for Australian exporters. Some decisions on the application of CN policies to EFIC were made in December 1997. This RIS addresses other appropriate changes.

### **Options**

The following options are examined:

1. Incorporating EFIC under the Corporations Law;
2. Charging EFIC for the use of its Commonwealth guarantee in relation to insurance and guarantees;
3. Removing the debt neutrality charge for medium-term borrowings;
4. Applying a taxation equivalent regime to EFIC's short-term business from 1 July 1998;
5. Subjecting EFIC to business laws from which it is now exempt; and
6. Funding community service obligations (CSOs), either through the Budget or through "notional revenue", both involving a commercial rate of return target, or internally through a reduced rate of return target.

**Option 1** is seen as incompatible with EFIC's role to encourage and facilitate exports. Incorporation under the Corporations Law would limit the capacity of EFIC to accept risk on EFIC's own account. This arises from the Corporations Law requirement to apply a commercial test to what is acceptable risk. This could be expected to result in EFIC taking on significantly less business on its own account, probably limited to what is reinsurable and a consequent shift of much new business to the government through the National Interest Account. This could be expected to have a significant effect on the availability and speed of cover for SMEs, as support for National Interest business could not be assumed, and the decision making process can be lengthy. EFIC would therefore be unable to fulfil its market gap role effectively.

It will, therefore, not be possible to have complete CN with EFIC and have EFIC retain its current market gap role. Implementing the changes already agreed and the options below considered feasible will be sufficient to achieve the principal aims of CN policy.

### **Impact analysis (costs and benefits) of the remaining options**

The remaining options are not mutually exclusive, and may be implemented independently of each other (i.e. none depends on any of the others being implemented). They have all been put forward as ways to enhance CN in EFIC's operations.

#### ***Option 2: Charging EFIC for the use of its Commonwealth guarantee in relation to short-term insurance***

It is possible that EFIC has an unfair advantage by having a government guarantee, whereas the private sector can only share risk through reinsurance, for which it pays.

The benefits of any charge would be revenue to the government (paid ultimately by exporters) and placing EFIC on a more equal footing with private sector insurers in respect of payment for reinsurance, removing a source of complaint.

To the extent that EFIC is unable to absorb a guarantee charge it will result in increased prices and a reduction in the competitiveness of Australian exporters *vis a vis* foreign competitors, many of whom have access to government-supported insurance. As a rate will need to be set by the Minister for Trade, it is impossible to quantify any effects at this stage.

#### ***Option 3: Waiving the debt neutrality charge for EFIC's borrowings on medium-term business***

EFIC has paid the debt neutrality charge (formerly the government borrowing levy) on its borrowings to date. This was set at 0.125% of borrowings. These borrowings are entered into only to fund its medium/long-term loans. As noted above, this business is considered to be non-commercial and there is therefore no reason to apply CN.

Should EFIC ever borrow to support short-term operations of its own account (e.g. to fund a major rescheduling), it should continue to pay the charge, to ensure that the borrowings are on a competitively neutral basis. To ensure that this happens, EFIC could continue to provide a statement of its borrowings on the day the debt neutrality charge payment is due, but now separating the borrowings into two categories - those used in support of short-term business and those used in support of medium/long-term business. It would then pay the charge only on the borrowings in support of short-term business.

In practice, this change will have no impact on EFIC's business, unless borrowings to support short-term operations are necessary at some point.

#### ***Option 4: Applying a taxation equivalent regime to EFIC's own account short-term business from 1 July 1998***

While EFIC is to pay tax on the short-term operations of its own account from 1 July 1998, this has not yet been implemented and the mechanism is still to be decided.

Levying income taxation on EFIC's short-term business would be very difficult to implement, and may require extensive monitoring by the Australian Taxation Office to ensure that capital costs and other expenses are properly allocated between short-term and medium/long-term activities of its own account. A possible approach could be to require "tax equivalent payments" (equal to 36 percent of accounting profits) to be paid on EFIC's short-term activities. While this may not be as accurate as levying income tax directly, the transaction costs are considerably lower. This arrangement could also apply to any liability EFIC should have for State taxes. An amendment to the EFIC Act would be required to implement tax equivalent payments.

### ***Option 5: Subjecting EFIC to business laws from which it is now exempt***

It is possible that EFIC has an unfair advantage due to its exemption from various laws. While it is exempt from the laws discussed below, EFIC is already subject to the *Trade Practices Act 1974*.

A discussion of the four business-related acts which provide an exemption for EFIC follows.

#### ***1. Financial Corporations Act 1974***

The object of this Act is to assist the Australian Government to achieve effective management of the Australian economy by providing a means for:

- (a) the examination of the business activities of certain financial and trading corporations; and
- (b) the regulation of those activities for the purpose of contributing to economic stability, the maintenance of full employment, the efficient allocation of productive resources, the ensuring of an adequate level of finance for housing and the economic prosperity and welfare of the people of Australia.

The Act applies to a corporation if, and only if, the corporation is a foreign corporation, a trading corporation formed within the limits of Australia or a financial corporation so formed, and it meets certain criteria such as its principal business activity is the provision of finance and that a specified proportion of its assets are located in Australia.

This Act does not apply to a corporation if the corporation, not being a company, society or association, is established for a public purpose by a law of Australia, of a State or of a Territory.

EFIC is captured by the exemption as it is established for a public purpose.

#### ***2. Insurance Act 1973***

This legislation is the primary Commonwealth law regulating the general insurance industry. It details the requirements a corporation must meet in order to be authorised by the Insurance and Superannuation Commissioner to carry on insurance business. It also stipulates certain obligations for insurers in relation to their business practices and details the powers of the Commissioner to investigate insurance corporations. The Commissioner has power to investigate insurers and revoke their authority to conduct business under certain circumstances.

The Act also imposes financial requirements upon insurers, such as the relationship between assets and liabilities, and obligations in relation to reinsurance. The Commissioner or Treasurer may also stipulate additional financial conditions upon an insured. EFIC is specifically exempted under section 5.



Inclusion of EFIC under the full prudential requirements of the Insurance and Superannuation Commissioner (ISC) would mean that EFIC would be required to operate as if it had no Commonwealth guarantee. While this action would place EFIC on the same basis as commercial insurers, it would also mean that EFIC would also be able to accept only risks that commercial insurers could accept i.e. those that are able to be reinsured and within the ISC's insolvency guidelines. This would effectively prohibit EFIC from undertaking its "market gap" role, i.e. to underwrite exports which are not acceptable to the commercial insurers - either because of the degree of risk or the contract's nature or size. Additionally, the application of this Act to EFIC may require a re-examination of EFIC's capital base.

Making EFIC subject to the Insurance Act would also require EFIC to meet certain capital adequacy and reinsurance requirements as well as particular reporting requirements. The capital adequacy requirements are not operationally relevant to EFIC given its Commonwealth guarantee. Given the requirement on EFIC to engage in non-commercial transactions it is not feasible to withdraw the guarantee. The non-commerciality of some of EFIC's short-term business on its own account would also prevent it meeting the reinsurance requirements of the Act. However, were EFIC to satisfy the reporting requirements of the Act, this would provide greater transparency and comparability with private sector organisations.

### *3. Insurance (Agents and Brokers) Act 1984*

This Act is designed to strengthen the financial stability of the insurance industry overall, to protect the insuring public against the negligence or misconduct of agents and brokers, to encourage practices consistent with the interests of the insuring public and to maintain standards of conduct of good quality of advice offered by agents and brokers.

The Act applies to all insurance intermediaries other than those whose business relates solely to reinsurance contracts, registered health benefits insurance, contracts involving State or Territory insurance or insurance entered into by EFIC under the *Export Finance and Insurance Corporation Act 1991*. The aim of this Act is to protect consumers and EFIC's exemption could be removed. EFIC makes limited use of brokers so this will have minimal impact on business. The exemption could be maintained for National Interest and medium/long-term business on its own account.

### *4. Insurance Contracts Act 1984*

This is an Act to reform and modernise the law relating to certain contracts of insurance so that a fair balance is struck between the interests of insurers, insureds and other members of the public and so that the provisions included in such contracts, and the practices of insurers in relation to such contracts, operate fairly, and for related purposes. It imposes operational strictures on commercial insurers and increases protection for consumers.

There are a number of exceptions to the application of the Act in relation to contracts or proposed contracts of insurance. These include contracts or proposed contracts of reinsurance, of insurance entered into by a registered health benefits organisation, of insurance entered into by EFIC or a friendly society, entered into in relation to the Marine Insurance Act 1909, and entered into in relation to worker's compensation or motor vehicle injury compensation.

There appear to be no sound reasons to maintain EFIC's exemption from an Act which aims to protect consumers. The exemption should be maintained only for National Interest and

medium/long-term business on its own account because of the non-commercial nature of such business. Also, the Act's requirement that anyone refused insurance must be given reasons is considered inappropriate for National Interest business, given that decisions may be made by the Government on consideration of sensitive information.

To the extent that EFIC's operations change as a result of the above exemptions being removed, EFIC's customers will be affected. It would, however, bring the relationship into line with normal business practice, and so it should not be detrimental to business.

***Option 6: Funding community service obligations (CSOs), either through the Budget or through "notional revenue", both involving a commercial rate of return (ROR) target, or internally through a reduced rate of return target***

Community service obligations (CSOs) are goods or services which the government directs a Government Trading Enterprise (GTE) to provide under certain conditions (including price), and which the GTE would not, on commercial grounds, provide under those conditions. Identified short-term insurance support for major exports, support for SME exporters and medium-term support for capital goods and projects are possible CSO elements within EFIC's business.

Setting EFIC a commercial ROR target and funding any CSO activity would remove any incentive for EFIC to undercut the private sector on commercial business. An alternative would be to recognise that because EFIC cannot charge a "commercial" price for some of its business (e.g. where the risks are higher than the market will bear or when servicing SMEs with relatively high transactions costs for relatively small amounts of business) to allow it to earn a lower ROR, with the reduction to depend on the extent of its CSO activity.

The effectiveness of any arrangement will depend on the accuracy with which CSOs can be costed. Notionally, EFIC should be setting a commercial rate for each transaction and then allocating an amount of subsidy in accordance with government guidelines to reach the price charged to each customer. For commercial transactions the subsidy would be zero. As transactions became less and less commercial the subsidy would be an increasing proportion of the notional commercial premium. In practical operational terms the judgement as to the commerciality of particular transactions has to be left to EFIC.

The more accurately CSOs are costed the less scope there is for such misallocation of CSOs. However, the scope for misallocation is independent of whether CSOs are budget funded, notionally funded, or internally funded.

Budget funding of CSOs would ensure that the government makes an explicit decision each year about the level of support EFIC was to deliver to exporters. It would also mean that EFIC would know at the beginning of each year the quantum of CSOs it was to deliver. Of course there would need to be scope for supplementary funding to respond to events like the current East Asian economic crisis. Budget funding of CSOs would also be more transparent. The alternative of internal funding with identification of CSOs in EFIC's financial reporting would provide the same public information but may not be as successful in focussing attention on the issue.

The CN guidelines provide an alternative where Budget funding attracts unreasonably high transaction costs as would appear to be the case with EFIC. The alternative involves a notional addition to revenue, which would be a transparent addition to EFIC's financial result and used to adjust the ROR measurement. The precise details of how this could be implemented would still need to be determined, but it will require EFIC to identify and cost the CSO element of its

business. This information would be used to determine the level of notional funding required to compensate EFIC for its CSO activities for the purposes of assessing its financial performance.

Notional funding of CSOs should have no direct effect on EFIC's operations and therefore no adverse effect on business is expected. It would result in more transparent information against which to assess private sector complaints.

### **Consultation**

Australian exporters, particularly SMEs, and private sector providers of export credit insurance would potentially be affected by any changes proposed. There would be no direct effect on consumers.

The major private insurer has been consulted on the above issues. EFIC has also provided its perspective on the issues raised. There has been no formal consultation with exporters. Relevant Commonwealth departments have been consulted on the issues.

### **Conclusion and recommended options**

The following options appear feasible for EFIC's own account:

- charging EFIC for the use of its Commonwealth guarantee in relation to short-term insurance, at a rate to be determined having regard to the needs of exporters for competitive insurance and guarantees;
- removing the debt neutrality charge for EFIC's borrowings in support of medium/long-term business only;
- applying a taxation equivalent regime to EFIC's short-term business from 1 July 1998;
- subjecting EFIC to the *Insurance (Agents and Brokers) Act 1984* and the *Insurance Contracts Act 1984* (with the current exemption to be maintained for National Interest and medium/long-term business);
- requiring EFIC to prepare financial accounts which accord with the requirements of the *Insurance Act 1973*; and
- funding CSOs through notional revenue, with EFIC having a commercial rate of return target.

### **Implementation and review**

The preferred options would need to be implemented by legislative amendment (to modify the current exemptions from business legislation and to provide for a guarantee charge for insurance and guarantees) and administrative action (to require EFIC to report along the lines of the *Insurance Act 1973* and to provide notional funding in assessing EFIC's financial performance). The Government's earlier decision that EFIC pay tax on its short-term business will also require legislative amendment, which may be undertaken at the same time.

The preferred options should have minimal impact on users. The main effect on business will be that any policies with EFIC will now need to comply with the *Insurance Contracts Act 1984*. While this will be a change, it will bring EFIC's practice into line with all other insurers, and therefore should not impose a burden on business.

CN, of itself, will not result in increased prices to users. The rate of return target will encourage EFIC to act in a commercial manner, including controlling its costs. The Government's notional funding of CSOs will mean that there is no pressure to raise prices for those who rely on EFIC's services. Any price increases would only be as a result of a subsequent Government decision that one or more CSO activities currently undertaken by EFIC are no longer appropriate and that there would therefore be no notional funding for them, leaving EFIC to conduct such business on a commercial basis. The measures taken will provide more information on EFIC's operations, including the costs of the various CSO activities, and thereby provide a better basis for any Government decisions.

The Government will monitor the effect of the changes, at least annually when considering the annual report and corporate plan of EFIC.