16

A Canadian Perspective

A. IAN GILLESPIE

I firmly believe that the US Export-Import Bank, or any other export credit agency (ECA), should not consider the Canadian Export Development Corporation (EDC) model a competitive threat, but rather an opportunity. It is an opportunity to embrace a model that ultimately addresses customer needs-–exporter and foreign buyers alike. And it is an opportunity for ECAs to play a critical public policy role, without distorting trade. With this in mind, I want to touch on three broad topics.

First, I want to consider why, historically, there have been different national approaches to export financing. Second, I want to state what we in Canada believe are the key principles for national export credit systems that operate on commercial principles. And third, I want to suggest some ideas on the future of the Organization for Economic Cooperation and Development (OECD) export credit Arrangement; its status vis-à-vis the World Trade Organization (WTO); and what it means for the United States and for other countries.

The Canadian Approach to Export Financing

Export financing systems around the world have evolved along rather different lines, and continue to evolve. The reason for different approaches among nations is really quite simple: each export credit system was

A. Ian Gillespie is president and chief executive officer of the Export Development Corporation (EDC).

established to meet the specific needs of its nation. Countries have different economic and industrial structures, different banking and insurance systems, different capital markets, and different public policy priorities. With each nation's economic needs and evolution varying so widely, it is not surprising that each export credit system has evolved along different lines.

Because ECAs all have different mandates, driven by different national needs, we need both to understand these mandates and to respect our national differences. Exporting one national system to other countries will not work, because the fundamental conditions and resulting national needs are not the same. We do not need one export credit model. But we *do* need a common understanding, based in world trade law, of principles that avert trade distortion.

With these thoughts in mind, I will describe the specific needs of the Canadian system and how EDC has evolved into a highly commercial organization.

Trade is a critical factor in Canada's economic health. Its exports are equivalent to more than 40 percent of Canadian GDP. This is among the highest levels in the OECD, and nearly three times the US figure. On the surface, the results might suggest that Canadian companies enjoy adequate access to trade finance. However, on closer examination, the reality is less positive, especially for the longer term.

First, Canadian trade is highly concentrated; five firms account for 20 percent of our exports, and the top 100 exporters account for more than 50 percent of total exports. Moreover, 85 percent of our trade is with the United States, and the Canadian share is falling in many other markets.

Second, foreign-owned firms continue to play a dominant role in the Canadian economy. Canadians are pleased that foreign corporations have chosen to invest in Canada and develop specific product mandates, and EDC can help bring additional foreign firms into Canada. But it would also be desirable for Canada to nurture more, as well as stronger, Canadian-controlled global companies. Transnational corporations are *the* driving forces in the global economy in terms of investment, technology, and research and development. Significant benefits flow to the home country from transnational corporate activity. Yet Canada is home to fewer than 2,000 of the roughly 60,000 transnational corporations that exist worldwide. Of these, only 3 make the list of the world's top 100. Canada thus is missing out on some of the benefits of globalization.

Third, despite worldwide growth in sources of private trade finance, Canadian businesses lack the financial strength to mobilize debt and investment financing to the same degree as their more highly capitalized international rivals. Consequently, Canadian firms face real challenges in mobilizing credit to support their international efforts. Canadian commercial banks focus on high-volume business lines in the broader North

American market, rather than on niche trade and project finance business. And foreign banks do not earmark their global trade financing expertise and capital to serve the relatively small Canadian market. They prefer to dedicate their expertise to global companies, few of which are Canadian. Therefore, Canadian exporters and investors find it difficult to locate trade finance partners with sufficient appetite for risk.

EDC is the only Canadian financial institution dedicated exclusively to the trade finance needs of Canadian companies. It has a clear public policy mandate: to grow Canada's capacity to engage in international business. EDC's focus, then, is to maximize the provision of trade-related financial services—essential for Canadian businesses entering foreign markets.

But EDC also has a commercial mandate. The Government of Canada decided more than 30 years ago that the Canadian Treasury could not compete with other major industrial countries. In a world of subsidies, it would inevitably be the loser. EDC is therefore expected to be financially self-sustaining, on the basis of commercial practices. By operating on a commercial basis, EDC minimizes market distortions, maximizes innovation, and even encourages private lenders to enter, or reenter, the market. It works easily with the private sector because it has the same competencies, speaks the same business language, and even shares the same skills and experience.

This has led to the growth of an ECA that operates according to a "business" model, one of paid-in capital rather than the more traditional model of an annual appropriation. This ECA model has generated a profit in 55 of its 56 years of existence. This model offers the Canadian taxpayer an excellent return on his or her investment.

Just consider that less than $1 billion of share capital invested in EDC, received during a 56-year period, has supported more than $300 billion in exports and foreign investment, with further obvious multiplier and induced effects. And there is no opportunity cost on the almost $1 billion "invested" in EDC. It earns financial returns on the investment greater than the government's cost of borrowing. This model, then, has a long-term track record of success. It is a model that clearly works for all stakeholders—exporter, foreign buyer, and taxpayer. Given EDC's commercial values and practices, it should be no surprise that EDC espouses commercial values in international discussions and tries to identify commercial reference points for the practices of other ECAs.

Characteristics of a Commercial ECA

Before outlining the more tangible characteristics of a commercial ECA, it is important to recognize the foundation of any high-performing organization: an innovative commercial corporate culture or mind-set.

Without the right culture, without the right people, it is not possible to be a commercial ECA. We are talking about gathering a group of highly skilled people who share a certain mind-set; they cannot be satisfied with the status quo. Indeed, EDC has the largest pool of trade finance expertise gathered under one roof in Canada. This goes a long way toward creating an innovative corporate culture, one that is committed to providing the highest-quality service and expertise.

EDC's experience has led it to certain conclusions about how a commercial ECA operates. These include some best-practice commercial tests: the ECA's governance relationship with the government, its financing structure, its accounting practices, its underwriting practices, and how it acquires and manages its assets.

- *A commercial ECA holds a clear mandate from its government*. On the basis of this mandate, it sets out specific policies and follows these policies in its day-to-day operations. Operating at arm's length from the government, the ECA's decisions are based on commercial principles and practices. Commercial ECA decisions are not politically driven.

- *A commercial ECA is held accountable for the decisions it makes*. Arm's-length operation from the government helps to ensure that there is a hard budget constraint—no annual appropriations cover administrative expenses or loan losses. Even further, accountability requires a positive net income target, ideally measured against share capital. Positive net income and retained earnings are how to grow a capital base. Breaking even is not good enough. Setting the bar too low inevitably discourages excellence in an organization's practices and allows it to hope for a better tomorrow that never comes.

- *A commercial ECA applies accrual accounting*. This forces the ECA to reflect a transaction's risk level in its income statement from the time it is underwritten. The ECA cannot afford to record the premium, sit back, and hope that nothing will go wrong. Reserves reflect an expected loss methodology, not some arbitrary ratio against business covered.

- *A commercial ECA follows clear underwriting methodologies and procedures for assessing and structuring a transaction, pricing the risk, and approving the deals*. The methodologies and procedures employed reflect best market practices. A transaction needs to be benchmarked against what is available in the market. A commercial ECA therefore must have the necessary tools and capacity to gather market intelligence and to ensure that transactions are consistent with market practice. This requires a good relationship with market intelligence providers and a strong connection with private-capital markets. These elements are facilitated when an ECA has its own treasury operations.

- *A commercial ECA makes full use of available risk-mitigation techniques*. The question is not whether a transaction is good enough; the question is whether the best possible deal has been structured.

- *A commercial ECA takes a portfolio approach to its underwriting and asset management*. It sets exposure limits on the basis of the risks of countries, sectors, or borrowers, and in relation to its own capital base.

One might ask, why, then, is a commercial ECA still an export credit agency? Why has it not been privatized? The answer is that a commercial ECA fulfills public policy objectives that the private sector, mandated by profit, cannot. The ECA can take on higher levels of risk in a greater number of markets, including emerging markets. It can provide higher levels of assistance to market segments not entirely serviced by the private sector, such as small exporters. It can create the right conditions in emerging markets for the return of private capital. And it can avoid subsidies entirely, while at the same time conservatively provisioning for the future. At the end of the day, the commercial ECA's ability to combine the best of public policy with the best of private practice results in a highly valuable tool.

I have addressed the characteristics of a commercial ECA in some detail because, taken together, they reflect a specific mandate and philosophy. An ECA that meets only some of these criteria, or does not meet them consistently, probably does not have a truly commercial orientation. It will likely be tempted to provide certain advantages to its customers that go beyond what would be commercially sustainable.

The Future of the OECD Arrangement

Where does this leave the OECD Arrangement? If some countries see it in their interest to have ECAs that operate on commercial principles and engage in commercial transactions much like private market participants, and if a common understanding can be developed for the parameters that guide the activities of commercially oriented ECAs, why would these ECAs still be expected to adhere to an Arrangement that was drafted with another type of institution in mind—a noncommercial lender of last resort? Those familiar with the OECD Arrangement will recognize the so-called market window debate behind these questions. EDC's view, and Canada's view, has always been that it is legitimate for ECAs to do commercial business on commercial terms. But let me set aside this old and rather stale debate. Recent developments at the WTO will, I believe, force all ECAs and their governments to rethink their export credit model.

The Brazil-Canada WTO Case

EDC has had recent experience in the dispute between Brazil and Canada on the issue of prohibited export subsidies for regional aircraft. Among other things, Brazil alleged that EDC's export credit commercial activities granted prohibited export subsidies. Brazil's challenge on this account did not succeed. Canada was able to demonstrate that its export credit practices follow the principles for commercial behavior that I have elaborated. The WTO decision provided guidance on what is considered a subsidy in the field of export credits, with implications beyond Brazil and Canada, or regional aircraft. In a nutshell, the WTO took the perspective of the buyer or recipient of the export credit. An ECA is not providing a subsidy if the financing does not confer a benefit. An ECA's financing does not confer a benefit if the terms and conditions of the financing are no more favorable than those that are otherwise available to the borrower in the commercial marketplace.

Canada has embraced this WTO concept and proposed a WTO-consistent definition of "official support" to the OECD Arrangement. In Canada's view, the Arrangement should solely be concerned with those export credit activities that are extended on terms and conditions that are more favorable to the borrower than those available in international capital markets, and are therefore considered a subsidy by the WTO. Only those activities that provide a subsidy need the safe harbor that exists under the WTO Agreement on Subsidies and Countervailing Measures (SCM). Nonsubsidy activities—market activities undertaken by commercial ECAs—do not need to rely on this safe harbor, because they are not subsidies in the first place.

There appears to be an implicit understanding at the OECD that *all* Arrangement-based activities can automatically be defended against a WTO challenge by invoking the safe harbor provision of the SCM. This is not the case. Canada just recently learned, through the WTO Compliance Panel process involving the Brazil-Canada case, that only certain specific Arrangement practices fall under the safe harbor. Canada had believed that a commitment to comply fully with the Arrangement was enough to satisfy the WTO and Brazil that Canada's national-interest-account business was consistent with the safe harbor under the SCM. The WTO panel disagreed. In fact, the panel's ruling says that *only* Commercial Interest Reference Rate (CIRR)-based direct lending falls under the safe harbor. The panel's rationale is that the interest-rate provisions of the OECD Arrangement, referred to in the SCM, exclusively cover CIRR-based financing.

What the WTO Ruling Means for the Arrangement

The WTO panel's ruling is of great importance to all Arrangement participants. Under this ruling, guarantee and insurance business is *not* protected by the safe harbor of the WTO. Any floating-rate business is not protected. "Matching" is not protected. These Arrangement-based activities may well be prohibited export subsidies if a benefit is conferred beyond what is available to a borrower in the commercial marketplace. What lessons are there to be learned from this experience?

Canada believes that Arrangement participants need to concentrate on the elimination of their subsidy business, such as tied-aid and interest-rate support, rather than attacking commercially based activities for which the WTO has already provided clear guidance.

- In view of the WTO outcome, it would be beneficial if Arrangement participants could arrive at a more complete understanding of the principles that underpin the activities of truly commercial ECAs. Otherwise, those ECAs that are operating commercially will have their business development frustrated by the trade-distorting activities of other ECAs. Canada certainly does not want to see market windows used as an excuse to provide subsidies under a different name. A subsidy under another name is still a subsidy. As I have already noted, commercial ECAs must operate under fundamentally different principles than those of traditional ECAs.

- If Arrangement participants want to defend their potential subsidy activities against a WTO challenge, they may need to rewrite the Arrangement. Every country will have its own priorities when negotiating such a redraft. Not surprisingly, Canada's priority will be to make the Arrangement more reflective of market practices. One example would be the explicit recognition of direct lending at floating rates, which shifts the interest-rate risk to the borrower. Indeed, we should be mindful of the possible entry into the Arrangement of emerging-market countries like Mexico, Turkey, or even Brazil one day. It is economically irrational to expect these and other emerging markets to use scarce fiscal resources to subsidize their banks or export credit agencies in order to offer CIRR fixed-rate credits under the Arrangement terms.

It seems to us that a more market-reflective, WTO-consistent Arrangement would be in everybody's best interest as we enter the new millennium. ECAs would save taxpayer money. They would stop distorting markets, particularly in developing countries. ECAs would be encouraged to underwrite business on the basis of commercial principles, even in those countries that do not yet have full access to international capital markets. This, in fact, could help emerging markets move away from traditional sovereign borrowing, and begin relying on more innovative and sustainable structures, such as asset-backed financing. This would be a true win-win situation.

Indeed, it is precisely a win-win situation that I have stressed here. EDC is not a competitive threat to the US Export-Import Bank or to other ECAs, but rather a potentially valuable frame of reference as they rethink their future orientation in an increasingly complex marketplace.