HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Reference: ANAO report—Commonwealth Guarantees, Indemnities and Letters of Comfort

CANBERRA

Monday, 2 June 1997

OFFICIAL HANSARD REPORT

CANBERRA

HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

Members:

Mr Hawker (Chair)

Mr Albanese	Mr Mutch
Mr Anthony	Dr Nelson
Mr Causley	Mr Pyne
Mrs Gallus	Dr Southcott
Mr Hockey	Mr Willis
Mr Latham	Mr Wilton
Mr McMullan	

Matter referred to the Committee:

ANAO Audit Report No. 6—Commonwealth Guarantees, Indemnities and Letters of Comfort

WITNESSES

HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON FINANCIAL INSTITUTIONS AND PUBLIC ADMINISTRATION

ANAO Audit Report No. 6—Commonwealth Guarantees, Indemnities and Letters of Comfort

CANBERRA

Monday, 2 June 1997

Present

Mr Hawker (Chair)

Mr Causley	Mr Mutch
Mr Latham	Mr Pyne
Mr McMullan	Mr Wilton

The committee met at 10.25 a.m.

Mr Hawker took the chair.

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Financial Institutions and Public Administration inquiry into the Australian National Audit Office performance audit No. 6, entitled *Commonwealth Guarantees, Indemnities and Letters of Comfort*. This is the fourth hearing this committee has held since it commenced the inquiry in late 1996. The committee has already heard from the Audit Office, the Department of Finance and a number of government business enterprises.

The audit report has identified significant shortcomings in the management of guarantees, indemnities and letters of comfort by a number of government agencies. Poor management of these instruments has resulted in a number of costly claims against the Commonwealth in the past.

The committee has already examined the Department of Finance's central role in ensuring the departmental management of these instruments is of a high standard. At today's hearing the committee will be hearing from the Department of Industry, Science and Tourism and the Export Finance and Insurance Corporation. The committee hopes that today's hearing will provide some useful insights into the relationship between a government business enterprise and its portfolio department and how they cooperate in managing the Commonwealth's exposure to guarantees, indemnities and letters of comfort. This is an aspect of management of these instruments that was not canvassed in any detail in the audit report. There is a concern that, as many GBEs make greater use of guarantees and indemnities than departments, the risk to the Commonwealth is greater with respect to the government business enterprises.

As the committee has a busy schedule today I will not take any further time. We will get the proceedings underway.

COLLINS, Mr John, Head of Credit, Export Finance and Insurance Corporation, 22 Pitt Street, Sydney, New South Wales

SMITH, Mr John Slater, General Manager, Credit Policy and Risk Management, Export Finance and Insurance Corporation, 22 Pitt Street, Sydney, New South Wales

ROBERTS, Mr Michael Roy, Director, Export Credit Policy, Department of Industry, Science and Tourism, 22 Allara Street, Canberra City, Australian Capital Territory

SMALE, Mr Donald Charles, Assistant Secretary, International Branch, Department of Industry, Science and Tourism, 22 Allara Street, Canberra City, Australian Capital Territory

CHAIR—Before commencing, I have to remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of parliament.

The committee has received the Export Finance and Insurance Corporations's submission No. 1 and it has been authorised for publication. Are there any corrections or amendments you would like to make to the submission?

Mr Smith—No, there isn't.

CHAIR—Do you wish to make an opening statement before I invite members to proceed with questions?

Mr Roberts—No, we don't.

CHAIR—I might kick off. You have seen the new guidelines from the Department of Finance for the issuing of guarantees, indemnities and letters of comfort. Do you have any comments about that?

Mr Roberts—No, we don't. I would like to say that it is likely that report went to the management area of our department with overall responsibility for adherence to the Department of Finance guidelines. It hasn't specifically come to us in relation to our contact with EFIC on a day to day basis.

CHAIR—In terms of accountability you would still see your role continuing through to Finance as it was? You are already complying with this, as I understand it.

Mr Roberts—For the department, I cannot say, I am sorry. In relation to our responsibilities for EFIC and EFIC's relationship with the minister, I can answer questions, but specifically on that I cannot answer them.

CHAIR—In terms of EFIC's exposures, are you satisfied that you get timely advice on that?

Mr Roberts—Yes. Perhaps I could explain that. Through parliament's approval of regulations, EFIC is constrained as to the maximum liabilities that it can commit the government through the government's guarantee under its act. There are three separate regulations—on loans, which is $3.5 billion, on insurance and guarantees, which is $3.6 billion, and on overseas investment insurance, which is $750 million. Those, as I say, are the regulations set by parliament and EFIC cannot exceed those levels.

Through the department, through its membership of the EFIC board—our secretary is on the EFIC board—we receive all EFIC board papers and EFIC reports regularly to its board on its liabilities under all its different products, so certainly on a monthly basis we get a very detailed report on all EFIC's liabilities.

CHAIR—Getting back to the guidelines, these are of course similar to those that are already in place. Does your department report regularly to Finance on this? How does it actually occur? I know you said you were a bit unsure under the new guidelines, but under the old guidelines?

Mr Roberts—EFIC's corporate plan goes directly to the Department of Finance every year under the normal approval mechanism, so the Minister for Finance is involved there. We provide quarterly returns to Finance on national interest liabilities that the Commonwealth has, and we provide Finance in relation to information on EFIC's commercial account as they request it. For instance, we passed across EFIC's six-monthly return only last week when they asked us for it. They have not evinced the need to have that sort of report on a regular basis.

CHAIR—What has been your response to the Audit Office report on guarantees et cetera?

Mr Roberts—Our response was very limited, and it was only on the issue that was raised in the ANAO report in relation to liabilities of the Commonwealth under the national interest provisions of the act. Our view there was that the wording that they had in there about the payment of claims through EFIC on national interest was a bit misleading, that it was not directly related to the Commonwealth guarantee of EFIC. It was in relation to the Commonwealth's statutory obligation in relation to national interest liabilities—two separate things.

CHAIR—This is where the difference in the amounts arose?

Mr Roberts—No, not amounts. It is in relation to whether the payments that have been to EFIC under national interest were payments under the Commonwealth guarantee of EFIC, and our view is that they were not.

CHAIR—In the annual report, the value of guarantees to EFIC is reported as significantly higher than the value listed in the Audit Office for the same date. How do you measure the difference in the value of the guarantee, or how do you measure the value? We have got two different figures there.

Mr Roberts—I am not sure of the difference.

CHAIR—EFIC says:

The exposure of the Commonwealth through its guarantee of EFIC is represented by the aggregate of Off Balance Sheet

Contingent Liabilities and the Balance Sheet Liabilities of the Corporation.

In the DIST annual report the value of guarantees to EFIC as at 30 June 1995 is listed as $9.8 billion. However, the Audit Office report values EFIC guarantees for the same date at $6.3 billion. I am wondering why there is a significant difference.

Mr Smith—There should be a slight difference because I think the figures that we gave in our letter to the committee were as at a different date. We had not finalised our half-yearly figures at that time. We gave some figures based on our balance sheet as at 31 December. We did not have the December figures ready and we provided an amount as at 30 November 1996 of $3.161 million. I think you read the figure to be the 1995 figure, did you not?

CHAIR—30 June 1995.

Mr Smith—We would have to take that on notice so that we can reconcile those figures for you. We measure exposure on the basis of the maximum possible exposure. We have another measure, which is the actual exposure in existence at any particular time. So there can be some confusion over those numbers sometimes.

CHAIR—This was the Audit Office report for the same date, 30 June 1995.

Mr Smith—We would have to reconcile those for you. I do not know what the difference is.

CHAIR—It is a fairly big difference, though, so I am just wondering. There must be some reason.

Mr Smith—I am just wondering whether some of that is not the national interest exposure that Mr Roberts mentioned before which is not strictly an exposure in relation to EFIC's business because it is a direct obligation under the national interest provisions of EFIC's legislation. That may account for some of the difference.

CHAIR—For some of it.

Mr Roberts—For some of the difference, yes. The figures you mentioned, I think, were $9.8 billion and $6.3 billion. Certainly, if you add the national interest liabilities to EFIC's own, you still will not get to the $9.8 billion. I will have to look into that for you.

CHAIR—It is in appendix 2 of the audit report, pages 72 and 73.

Mr Smith—Certainly our figures at the end of 1995 were as represented in our annual report, which is fully audited by the Audit Office.

Mr Roberts—The figure there is a combined figure for AIDC and EFIC. EFIC's liabilities there are $3.35 billion.

CHAIR—Yes. But then on the next page, under ‘non-loan guarantees’, there is a further $2.956 billion. So if you add those together, you get the $6.3 billion.

Mr Roberts—Right.

CHAIR—That is EFIC only.

Mr Roberts—Yes, I could agree with that.

CHAIR—I am just wondering why there is quite a big difference.

Mr Smith—EFIC counts the on-balance sheet exposure plus its off-balance sheet exposure, which in respect of its off-balance sheet exposure is our contingent liability arising from our insurance operations. So the difference between the $6.3 billion and the $3.3 billion may well be the off-balance sheet contingent liability represented by our insurance operations.

CHAIR—Rather than pursuing this any further, maybe you can give us something in writing to explain that difference.

Mr Roberts—Yes. I would just like to be clear on the $9.8 billion, if you could explain exactly what that reference is.

CHAIR—In EFIC’s report, it says:

The exposure of the Commonwealth through its guarantee of EFIC is represented by the aggregate of off-balance sheet contingent liabilities in the balance sheet

- liabilities of the corporation. In the DIST annual report, it says:

The value of the guarantees to EFIC as of 30 June 1995 is listed at $9.8 billion.

Mr Roberts—Thank you.

CHAIR—If you could give us that in writing, that would be great. I am sure other members of the committee have some questions.

Mr McMULLAN—As Mr Smith would know, I am quite a fan of EFIC and have worked with it in the past. I think most of what it does is excellent. But I am interested to get on the record the criteria you use to determine what you will take on the commercial account and what you refer to cabinet for decision under the national interest account.

Mr Smith—The criteria, as far as EFIC is concerned, is that what is suggested for consideration by the government on the national interest account is business that, for reasons of its own commercial prudence—given the amount of risk that its own balance sheet can carry—is not acceptable for EFIC. There is a consultation process involved whereby, if we identify a piece of business which we believe may be of interest in the national interest to government, we do not take a position on that piece of business other than to explain to government why that piece of business is not acceptable to EFIC on its commercial account. The government then decides whether or not that particular deal is in the national interest to consider. Then that decision is made, and if the decision is to provide support for that particular transaction, then EFIC will act on behalf of the government in implementing that decision and writing the transaction.

Mr McMULLAN—With whom do you consult? You say there is a consultation process. First of all, how does the business come to you? Is it through some Australian enterprise putting a proposition to you?

Mr Smith—More often than not that is what happens. The process of consultation is a fairly wide term. The company itself may be in discussion with the government on that particular project. The company may directly ask EFIC to submit a project for consideration by the government. Clearly, the formal process is a process whereby we take to our board that particular transaction. Our board makes the decision that it is not acceptable for EFIC's book, and then the business is simply offered to government for consideration.

The process of consultation is more of a technical nature where we brief the government through the letter that we write to the minister, copied to the department. We brief the minister on the technical aspects of the project and describe the areas of risk and risk mitigation which relate to that particular transaction. It is then for the government to decide whether to write the transaction.

Mr McMULLAN—These matters that are referred that you describe as not acceptable to the board of EFIC—is the criterion for that driven principally by the risk or the magnitude of the transaction?

Mr Smith—It can be either or both. It may be in a country which is high in risk, too high for EFIC to accept. It may be that we already have exposure in a particular country or in a particular sector which, if we went beyond our own internally identified limits, would take us beyond the realm of comfort. But it could be just plain risk of the transaction, regardless of the amount. Or it could be the size of the amount which would be too great for EFIC's balance sheet to bear.

Mr McMULLAN—What has been the pattern of the national interest account? Is it growing?

Mr Smith—It is growing of late. It comes and goes over the years depending upon what time period you assess it on. It has grown significantly in relation to wheat over recent times.

Mr Roberts—Wheat has been the major determinant on the size of the national interest account.

Mr McMULLAN—When you say 'over recent times', what do you mean?

Mr Roberts—Certainly in the last 12 months with the massive wheat crop we had. The Wheat Board has been looking to sell into only several credit markets, whereas it had many in the past. But those markets have taken quite large tonnages of Australian wheat.

Mr McMULLAN—Within the limits of confidentiality, what can you tell us about the transactions that have gone onto the national interest account? What are we guaranteeing in that last period?

Mr Roberts—As I said, wheat is the major component.

Mr McMULLAN—To whom?

Mr Roberts—To Iran and to Pakistan. I am not sure that Pakistan has actually purchased any, but the possibility was there for them to do so. Also, there have been a number of loans that have gone on the national interest account to other countries—Vietnam, for example. There are several other products that EFIC delivers for the government involving performance bonds and working capital guarantees. There has been a myriad of individual transactions that have been done under those two products.

Mr Smith—There have been a couple of mining projects over the last couple of years—one in Argentina and one in Papua New Guinea—where the risk of those projects was shared between EFIC's commercial account and the government on the national interest.

Mr McMULLAN—But the increase in size has actually been driven by the wheat changes?

Mr Roberts—Wheat mainly and, also, you would be aware that my minister has put an amendment to the EFIC act through the parliament to transfer the liabilities on existing DIFF loans—development import finance facility loans—that have traditionally been on EFIC's own commercial account. Those liabilities will be transferred to the government's national interest account. That will be a major increase.

Mr McMULLAN—Whatever I think about that, that is a paper shift. I am not concerned. At the end of the day, that does not change the government's liabilities. The decisions to take on new ones are what I am particularly interested in. Tempting as it is, Mr Chairman, we will make some political points about DIFF some other day in some other forum. Self-denying ordinance just for one day! I am interested in when we last took on an extra commitment with regard to national interest account guarantee for wheat sales to Iran. How recently?

Mr Roberts—There have been a number this financial year. I am not sure of the exact tonnage, but it is a significant amount.

Mr McMULLAN—Is that a longstanding policy to have that sort of guarantee to Iran? I know we have had it to Egypt. I remember that and some of the consequences of that. What about Iran?

Mr Roberts—From memory, Iran has been a purchaser of Australian wheat, from my memory, for probably five or six years. Mr Smith may have a better idea than I have.

Mr Smith—Yes, it is the Wheat Board's major credit market. We have been supplying wheat to Iran and the national interest facility has been supporting wheat to Iran for, I would agree, five or six years.

Mr McMULLAN—I do not know if you can answer this, but has there been any discussion about the possibility of sales to Iraq in the light of the United Nation's decision about allowing them to sell some oil for the purchase of food? I know we were a major supplier to Iraq. I am not sure what the national interest account's role in that was. Has there been any discussion about it?

Mr Smith—No, there is no current prospect of supporting wheat to Iraq under that oil for food arrangement. As I understand it, the payment mechanisms for that are UN controlled and, therefore, the—

Mr McMULLAN—There would be no need for the national interest account; there would be cash in the bank?

Mr Smith—The risk is probably acceptable without even EFIC support.

Mr Roberts—And the Wheat Board has been selling there on that basis.

Mr McMULLAN—Recently?

Mr Smith—Yes.

Mr McMULLAN—I am aware that they were a very big customer in the past. With regard to the commercial account, this is where you would regard the operations of EFIC as coming more within the conventional definition of the matters the Auditor-General is raising?

Mr Roberts—Yes, that is right.

Mr McMULLAN—Apart from DIFF, have there been any major changes in the pattern of the operation of the commercial account, either geographic or in terms of product mix, for what you are guaranteeing and to whom?

Mr Smith—No, most of our exposure for medium-term business is still in Asia. Our exposure for our short-term business, which is basically trade finance up to 180 days, is fairly more spread across North America and Europe as well as Asia.

Mr McMULLAN—With regard to the product mix that is being guaranteed, what is it now? Is it changing?

Mr Smith—The major change to our product mix would be that over the last 12 to 18 months or so we have introduced a facility whereby our medium-term support for finance for capital goods exports is now available not only through EFIC directly as a direct loan from EFIC to the overseas borrower, but also through the banking system. We have made an endeavour to widen the availability of our support to encourage the banks to provide this kind of medium-term finance with EFIC support to support capital goods exports.

Mr McMULLAN—With regard to the national interest account, I can recall we had to pay off the budget with regard to a national interest guarantee on wheat sales to Egypt. Have there been any other significant calls on the budget as a consequence of national interest account guarantees in recent years?

Mr Roberts—The direct call on the budget has been in relation to wheat payments to Iraq.

Mr McMULLAN—Yes, of course, because of the sanctions.

Mr Roberts—Yes, because of the sanctions. The other large national interest claims have been in relation to Egypt and Russia, but both of those were financed by EFIC off-budget. The only direct budget payments have been in relation to Iraq wheat.

Mr CAUSLEY—Didn't China default at one time?

Mr Roberts—Not in relation to national interest.

Mr CAUSLEY—With wool?

Mr Smith—There have been occasional contract repudiations with China, but they were all handled on EFIC's own commercial account. The reason the claims on Russia and Egypt have not hit the budget is that both of those countries have rescheduled their debt rather than default it outright. And so, under those rescheduling arrangements, they are repaying. EFIC has, under the direction of the government, borrowed to match the repayment schedules from Egypt and Russia, although the Egyptian reschedule did factor a 50 per cent discount—if you like, a forgiveness of 50 per cent—into the rather complex rescheduling arrangements which EFIC is financing under the direction of government.

Mr McMULLAN—I remember that Egyptian transaction. Members of the Paris club very generously made a decision which bound us! I remember it was very kind of them! I thought, as a consequence of that and as a consequence of the collective decision to discount Egypt's loan—which was, if we are being frank about it, essentially a payment for their generous activity during the Gulf War—we did take some payment off the budget to you or to the Wheat Board; certainly it came up in budgetary discussions.

Mr Smith—There are a couple of things. Firstly, the discounting is structured such that the principal amount is repaid, but the 50 per cent debt forgiveness is provided over a long term in relation to the interest rate that they pay, which is a subcommercial interest rate. The debt rescheduling caught EFIC's commercial account as well. Not only did the Paris club decide on behalf of Australia to give Egypt a debt rescheduling of 50 per cent forgiveness, but the Australian government decided to provide that on EFIC's commercial account as well, so we lost 50 per cent also. That might have been an issue that was discussed.

Secondly, there was an issue relating to the Paris club rules for selling rescheduled debt in the secondary market. That might have been an issue that had some cabinet discussion as well because we have sold some Egyptian debt in the secondary market.

Mr McMULLAN—Were all those losses—Egypt, Iraq and Russia—related to wheat?

Mr Smith—Russia was predominantly wool, but there was some wheat involved as well.

Mr McMULLAN—Wheat and wool in Russia; and wheat to Iraq and Egypt?

Mr Roberts—Yes.

Mr PYNE—Isn't EFIC responsible for the line of credit to Iran, over and above the national interest account to Iran?

Mr Smith—That is right.

Mr PYNE—What does that currently stand at? How much is the opportunity for them to draw down on?

Mr Smith—The line of credit is an uncommitted line, which means that there is no commitment at all between EFIC, the Australian government and Iran. The line of credit has a price tag on it, to give it some meaning, which was set back in 1991 at $US750 million. The arrangement is that EFIC and the Australian government have no commitment until a project is put to them for consideration. The decision whether or not to write a transaction is a decision made in relation to that transaction and circumstances existing at that time.

In prospect of the potential use of medium-term credit for Iran, EFIC and the government have agreed that it is likely that any use of medium-term credit for Iran would be a national interest issue to be considered at the time.

Mr PYNE—When was the last time any of the $US750 million was used by the Iranian government? Or has it never been used?

Mr Smith—It has never been used.

Mr PYNE—Has there been any renewed interest in that line of credit in the last six months from the Iranian government?

Mr Smith—No project has been put to EFIC for consideration under that line. There have been ongoing discussions from time to time. EFIC is in Iran frequently managing the national interest short-term risk, because clearly the wheat exposure is a major issue. We have actually been attempting to re-organise that line of credit so that we lessen the anticipation expectations of both exporters and Iranians that we could ever accommodate such an amount.

Mr PYNE—Is the $US750 million amount the largest to your knowledge in the world that is available to the Iranian government?

Mr Smith—As I said before, it is not technically available in the sense that it can only be considered on a project by project basis. It is an uncommitted line, so it is an arrangement where we agree to consider projects based on certain standard terms and conditions if a project was underwritten. In that sense, it is a zero line, but for a line that has a nominal price tag of $US750 million, it is certainly touted around the world as the largest of such, but it is a bit of a Clayton's figure.

Mr PYNE—Do you know which other countries still have that sort of arrangement with Iran? Does

Germany still have an arrangement with Iran?

Mr Smith—The Spanish have. There are certainly more countries than Australia who have actually provided medium-term finance to Iran; the Germans certainly have. I am not sure what the German limit or price tag is on the availability of their cover. A lot of the European agencies shortened the availability of credit to Iran when it hit some financial difficulties back in 1992-93, and a lot of Iran's short-term debt at that time was re-scheduled and the medium-term availability of credit was pulled back.

Mr PYNE—What sort of projects would be considered under this sort of line of credit?

Mr Smith—The line was envisaged to cover capital goods and services type projects. It was initiated back in 1991 when there was a very large sugar rehabilitation project envisaged in Iran which had the capacity to attract a lot of Australian sugar industry machinery manufacturing companies, as well as cane harvesters, sugar mills and in-field transporting equipment. Those companies initially were very interested in utilising the line.

More lately, there is a variety of Australian companies who have considered doing business in Iran. The amount of Australian interest in Iran in that capital goods field has lessened significantly since the line was first established because we have not been marketing it and because of the financial difficulties that the Iranian economy has had. The Iranians themselves have pulled back on contemplating medium-term credits. There has not been a lot of activity, frankly, over the last few years on the availability of such credit.

Mr CAUSLEY—I apologise for being late from another committee, but you may have discussed this. I have one question on the risk management area, which I think the ANAO report certainly dwelt on—the risk to government under certain guarantees, whether they are implicit or not, from agencies.

The fact is that you would probably be one of the big areas of risk because of the operations that you have. How do you assess foreign governments or foreign countries in this area? With the world trade agreement in place and probably some of the barriers coming down to countries we have not dealt with in the past, there would be a need to assess—and I suppose it is dynamic—because the economy has changed so quickly. How do you address that?

Mr Smith—We have a specialist country risk assessment unit that is populated by professional economists who access data from a wide range of sources. We have the normal commercially available data, but we also have privileged access to IMF and World Bank data, as well as privileged access through our government ownership, of course, through our embassies and analysts overseas.

We visit countries regularly. We talk to agencies such as ONA here about gauging country risk. We analyse individual projects and transactions in the context of that broader country risk analysis. Through Australia's membership of the OECD, we have access to comparative data with other agencies around the world, and we also belong to an association of export credit agencies globally, called The Berne Union, of investment and insurance companies.

That Berne Union meets twice a year. It has a very well-honed exchange of information system. We swap notes at our six-monthly meetings. We discuss a range of countries and nominate countries, as you say, of dynamic and changing interest to the group of countries that meet. Those Berne Union meetings are attended by the IMF, the European Bank for Reconstruction and Development, and the World Bank. We get privileged and up-to-date advice on the list of countries that are nominated. So, it is a broad range of sources.

CHAIR—On the question of prudential supervision, which I think relates to this, I was wondering: what is DIST's role in monitoring and advising on the activities of EFIC? Does it have a role in the prudential supervision of EFIC?

Mr Roberts—Yes, we certainly have a role. As I mentioned earlier, the secretary of our department is a member of the EFIC board. From that point of view, he is directly involved in individual transactions that come forward to the board for decision. But, apart from that, we have a role in advising the minister from time to time in relation to matters concerning EFIC's exposures, such as where they stand currently and where their corporate plan predicts they will be in a number of years time.

If, for instance, EFIC was approaching the limit of one of its regulations, it would be our role to put advice to the minister on whether the regulation should be increased, for example.

CHAIR—I suppose on the same line, insurance companies usually are regulated by the ISC. Do you feel that DIST has the same sort of expertise to monitor what EFIC is doing? I suppose, by the same token, would it be possible that some of that could be done by the ISC?

Mr Roberts—You are probably aware EFIC is what is called a government business enterprise. It was clearly established to act on commercial lines. It has been given a great degree of independence to do so. In relation to its own commercial account, I think it is fair enough to say the government has made a conscious decision that EFIC, through its board, is responsible for the management of its liabilities and, through its regular reporting to the department and the minister, to inform government of where it stands. The department, I think, has been very satisfied with EFIC's performance over the years in relation to its prudential management of its liabilities.

CHAIR—So you feel that the mechanism for accountability is adequate?

Mr Roberts—Yes, we do.

CHAIR—On the question of reporting, the same sort of thing. Does EFIC find it confusing having to meet reporting requirements of several different acts?

Mr Smith—I really do not find it confusing, but it is complex. We probably report to a far wider variety than most corporations. Our shareholder is in different guises and, as Mike said, we provide a corporate plan annually, which is required under our legislation. That corporate plans goes to our own minister as well as the Minister for Finance.

We have other reporting obligations that are listed in our submission through our minister, but we are controlled by the audit act in terms of our investments. We are controlled by the Treasurer in terms of our borrowings and various other pieces of legislation which we are bound by. It can be complex.

CHAIR—One of the problems identified in the audit report was the need to include financial limits and termination clauses and guarantees or indemnities. EFIC notes in its submission that the guarantees do include such limits, but does EFIC actually experience any problems with including such limits, and are there circumstances in which EFIC would not include such limits?

Mr Smith—It is not really possible to not include such a limit, because we are a financial services organisation. We sell people insurance policies and we lend people money. That has always got to be the subject of documentation between us and our counter party. Unless there is a figure in there it does not work. We basically are obliged, through our legislation and through the kinds of products we provide, to set a limit on the amount of our exposure every time we enter into such a transaction. It is the aggregation of those individual transactional limits that result in our being able to measure our exposure and report to government.

CHAIR—With the audit report, does DIST consider that guarantees for EFIC and the AIDC will be better managed as a result of that audit report—would you see any changes?

Mr Roberts—I cannot answer in relation to the AIDC. In terms of EFIC, EFIC's submission to the committee makes it clear that EFIC adheres basically to the recommendations of the report as it stands now. We have looked very carefully at what the report has said. We are generally satisfied that it does adhere to the recommendations.

CHAIR—Have you made any changes?

Mr Roberts—No, we have not made any changes.

Mr CAUSLEY—I was going to ask a question about hedging against your risks. I note that there has been a statement that EFIC does not really take that position, while other commercial entities probably would. On the interest rate and currency exposure, you do not cover those in any way?

Mr Smith—We do. A large amount of our currency exposure is mitigated by the fact that we only borrow in the currencies that we lend in. If we have been asked to lend $100 million to Thailand, for example, then we borrow $100 million from the capital markets and we lend basically that $100 million to the Thais. We are taking a risk that the Thais will not repay us. In the event that they do not, then we have got a mismatch between our borrowing and the fact that we have a borrower that will not repay us. That is no different from any other financial services organisation.

A major part of our currency exposure is mitigated by lending in the same currency that we are borrowing in, so we are not taking a position in any way on those currencies. We have fee income, for example, in US dollars that we do not necessarily hedge. Then again, it is difficult to hedge against an amount which is known, but the timing of the payment is unknown. Again, that is no different from most financial organisations.

When we anticipate making a loan, we will take the appropriate interest rate hedges to make sure that we are not exposed to movements in interest rates. An area of active derivatives management in EFIC is to make sure that we do not have those exposures. I think the reference in the report that we are not doing what is normal is actually a positive thing rather than a negative thing in the sense that, because we are borrowing in the same currencies that we are lending in, we have already mitigated the kinds of risks that some other financial organisations may have to use hedges for.

Mr CAUSLEY—Because you are supposedly an Australian government entity anyway, would you see yourself being in a stronger position than an individual would be in when borrowing in that country? You would probably put more pressure on them than an individual would, as far as repayment is concerned.

Mr Smith—In terms of managing the risk, that is right. It is a major positive for us that we can heavy the borrower, if you like, on the basis that we are a government lender. Because we also provide a wide range and a high volume of this kind of credit on behalf of Australian exporters, it is very important, in a sense, for any borrower to be accredited with the capacity to borrow from an export credit agency such as us.

CHAIR—By the way you manage the risk on currency and interest rates, you are, as far as possible, taking the risk out of it, aren't you?

Mr Smith—As far as possible, yes.

CHAIR—But at times there must be a fairly high cost to get that security. I do not know how you would describe it, but how would you compare, for example, with a commercial insurance company which, presumably, would take a higher risk approach?

Mr Smith—There are two kinds of risks here. One is the risk that we take when we are actually lending physical funds, when we are acting as a bank, in its broadest sense, where we actually need to physically transfer funds which are going to be repaid at some time in the future. In that sense, we are acting no differently from a bank. Our rates at which we borrow are very attractive because we are government guaranteed. We can borrow and enter the derivatives market at fairly fine pricing. Those costs are generally covered by the interest rate that we charge to our borrower, so we are fairly covered there.

On the insurance side, which is a contingent liability, when we are not physically lending any money, we have the risk that an event can trigger a call upon our guarantee or on our insurance policy. We do not enter into derivatives management in relation to those contingent liabilities, because you cannot measure when such an event might occur. Like insurance companies, we do not really enter into derivative risk management.

CHAIR—Or reinsurance?

Mr Smith—We do not reinsure. The vast proportion of our book is not reinsurable. There is a proportion of our book which is reinsurable, but, because of the nature of our activities, the commercial reinsurance market would not be interested in some of what we do. It could be interested in part of what we do, but not all of it.

CHAIR—Thank you. Are there any audit recommendations that you are having difficulty in meeting? Which of the recommendations have been the most difficult to provide a practical response to?

Mr Roberts—Again, I can answer in relation to EFIC only. We have had no problems with the recommendations because, as I have explained earlier, we are happy with EFIC's adherence to the recommendations in the past. Basically, all those are in place already.

CHAIR—Do you feel that the management of the guarantees will be as good as before, better or the same?

Mr Roberts—From the point of view of having an ANAO report, it does sharpen the mind remarkably. From that point of view, it will put additional pressure on us to ensure that the management of the guarantee is maintained at least at the same level as it was in the past.

CHAIR—Has the report helped to focus rather than to bring about any changes in methods?

Mr Roberts—Yes, that is correct.

Mr Smith—EFIC is separately audited apart from the particular audit that we are talking about here. EFIC's separate audit suggests improvements all the time. It is an ongoing thing that the National Audit Office audits EFIC's books quite separately.

CHAIR—As there are no further questions, I would like to thank all the witnesses who appeared before us today.

Resolved (on motion by Mr McMullan):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

Committee adjourned at 11.15 a.m.