

E-EXPORT FINANCE IS NO DOT-COM WONDER BUT WONDER WHAT EDC WILL MAKE OF IT?

David Clarke

Canadian exporters will soon have easy online access to a vastly wider array of financing alternatives. For Export Development Corporation, that means its traditional mandate is no longer relevant. A new mandate might focus on facilitating the e-commerce competitiveness of Canadian companies in the developed world, while whetting their appetite for more risky opportunities in the developing one.

Bientôt, les exportateurs canadiens pourront accéder en ligne à un vaste éventail de solutions financières, ce qui fera tomber en désuétude le mandat traditionnel de la Société pour l'expansion des exportations. Pour actualiser son mandat, la SEE pourrait se tourner vers le commerce électronique pour favoriser en ce domaine la compétitivité des entreprises canadiennes dans les pays développés, tout en aiguisant leur appétit pour les occasions d'affaires plus risquées offertes dans les pays en voie de développement.

For Export Development Corporation (EDC), the long siege that began in 1998 with the launch of the legislative review of the *Export Development Act* will finally be lifted this fall when Ottawa tables legislation introducing both significant structural changes, notably in the area of environmental accountability, as well as some window-dressing in the form of a name change (to "Export Development Canada"). Nothing in the legislation is expected to shake EDC's foundations, however.

That is not true of incoming volleys from a whole new kind of marauder, the high-flying purveyors of online export finance, including both online lending and online credit insurance. The newcomers come fully loaded with the usual dot-com hype over their near-term prospects, ammunition not nearly so intimidating as it once was. But, hype aside, they also have the very real potential of shattering existing bricks and mortar businesses. And their advent will complicate the policy issues surrounding export finance by transferring them to the slow-motion train wreck that is the global attempt to come to a consensus on how to regulate e-commerce. Since Ottawa hosted the OECD conference on e-commerce in 1998, progress has been barely measurable.

For financial institutions, including EDC, the Internet poses the deadly threat of "disintermediation"—industry

jargon for what happens when borrowers and lenders realize they do not need a third party to play matchmaker, or in fact take any role at all in their financial relationship. Disintermediation is what happened in the 1980s when corporations started lending to each other and created new "securitized" products (that is, markets in which corporate liabilities were bought and sold). That cut out the banks—until they adapted, largely by buying brokerage houses that could innovate their way back into the corporate finance market.

Granted, it will take a real earthquake to disintermediate EDC, which is a financing force to be reckoned with. In 2000, EDC programs facilitated \$45 billion worth of international business by Canadian companies. In total, EDC had some 5,700 "customers," of which more than 5,000 were small or medium-sized enterprises. In the process, it generated a net income of approximately \$200 million. This powerful Crown corporation has a broad mandate to support and develop Canada's exports by providing a wide range of financial and risk-management services to exporters—too wide a range, critics say. Thus insurers complain that competition has been curtailed because they can't match the clout of EDC's Government of Canada reinsurer, while bankers say that when they come to EDC for insur-

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ance on deals they have made they fear the Corporation will go back to the exporter later with a pitch for direct lending or some other service that they can't match.

But an earthquake is coming. No matter how dominant EDC may be, e-trade finance configurations currently in their infancy are soon likely to tempt its clients sorely. After all, if an ordinary consumer can use an online mortgage site to pit lenders against each other until he or she gets the best price, why shouldn't an export entrepreneur? The global banks that were so sorely pressed by new forms of competition in the 1980s were no slouches either. And it is unclear that a sovereign credit rating is much to offer a globalized private sector that these days is more creditworthy than most governments.

In announcing its new legislation for EDC, the Department of Foreign Affairs and International Trade (DFAIT) said the government agreed with the Standing Committee on Foreign Affairs and International Trade "that the EDC Board of Directors consider a number of changes to its operations to make it easier for small and medium-sized enterprises to access EDC's services, including the adoption of e-business solutions."

EDC has already put electronic forms and subscriber-based information resources on its website. And it has a major e-agenda, with many new online products under consideration to add to its recently launched digital "Bid or Performance Security Insurance." EDC's business plan makes clear its management is fully aware there is a global race on to find e-export finance solutions, and the stakes are high. But in fact the Corporation is far behind the competition. It ultimately has the resources to buy itself back into position, but only if it links up with others who have already paid hefty development costs. If EDC tries to go it alone, it will waste time it doesn't have re-inventing e-wheels while private sector players with much deeper pockets refine their online offerings even more.

Canadian exporters look to a variety of sources for their financing requirements. As far back as 1996, Canada's banks provided \$66 billion of credit facilities to exporters, including \$16 billion in letters of credit and \$3.5 billion in "documentary credits" (where the financial institution acts as a collection agent). In addition to the banks, credit unions also provide a range of export financing options, as do the Canadian subsidiaries of the larger general insurance

groups. And then there are several dozen major factoring companies in Canada, all of which assist exporters by enhancing liquidity through invoice discounting. The larger of these companies all offer virtual services already.

On the credit insurance side, a half-dozen small specialist firms and two dozen diversified firms include credit insurance in their product lines. There are also Canadian offices of the giant multinationals, most notably EULER American Credit Indemnity Company (EULER ACI), North America's largest provider of accounts receivable insurance. Last year, EULER joined with Bank of America (one of the world's largest banks), Amroc Investments (the largest broker of trade claims in the US), and eVolution Global Partners, LP (a venture capital firm), to launch an online platform that over the long term will be a daunting challenge for EDC, not to mention the micro Canadian outfits.

Meanwhile, the Canadian Commercial Corporation (CCC), which serves as the federal government's prime contractor and guarantor for sales by Canadian exporters to foreign governments and international organizations, is already one step ahead of EDC with an online sourcing service that represents a foot in the door of the arena known variously as B2B (business to business), extranets and virtual communities. But even CCC is behind its vastly larger competitor, Bank of Montreal/Nesbitt Burns, which not only has established a toehold but is engaged in a battle with the global banking giants. It is a war the Bank of Montreal BMO hopes to win by allying itself with Barclays Group PLC, Australia and New Zealand Banking Group and American Management Systems in a joint venture called "Proponix Trade Processing." Proponix will provide online transactions for services such as letters of credit, guarantees and reimbursements, and will allow customers to perform and track transactions online.

Proponix is an initiative with a lot of potential, not just in selling to exporters but to other banks. Online transactions processing for international trade banking services is an estimated US\$10 billion market, according to a BMO official. Financial institutions could potentially save 30 per cent by outsourcing trade banking. BMO's virtual merger also allows it to cut some regulatory corners. "If you were to try and merge three banks of this size there are just huge issues from a personnel, regulatory and a customer service perspective," the *Financial Post* quoted Harry Ort, national industry director for banking at consult-

ing firm KPMG LLP as saying. "You achieve many of the same benefits that you get by virtue of a merger."

Ironically, during the first, abortive round of merger talks, Finance Minister Paul Martin cut short any notion what he would listen to the banks' suggestion that e-banking could serve consumers just as well as branches. But in Proponix, a Canadian bank, two foreign banks and a US technology company have now formed a merger in all but name. And the EULER alternative is hovering out there in cyberspace, a star by which domestic credit insurers can navigate their way into an unmapped future that presumably includes online global linkages.

Further down the road than even Proponix has gone, US-based TradeCard Inc., an ambitious outfit now venturing into Asia and (through an alliance with Scotiabank, Canada) says its goal "is to provide businesses with a secure, reliable, cost-effective and user-friendly solution for conducting and settling international trade transactions." Its competitor, China Systems, already claims to be "the largest trade finance system vendor in the world."

But it is the Bolero International experiment that takes e-export finance to a whole other, truly global, level. In existence since 1995, this consortium is a vehicle for both the Society for Worldwide Interbank Financial Telecommunication (SWIFT) and the Through Transport Club (TTC). The goal is to provide a secure facility for the exchange of electronic trade documents that is ultimately accepted as the standard worldwide. The initiative would more than pay its start-up costs by eliminating even a small portion of the \$US400-500 billion that the UN estimates as the annual cost of paperwork involved in world trade. In the process, TTC members would also benefit from cost efficiencies. SWIFT, a bank-owned cooperative that provides messaging services to 6,500 financial institutions in 181 countries, naturally will try to ensure that they are not disintermediated as trade finance goes electronic. Freight carriers and banks that can claim to be "Bolero-ready"—and among Canadian banks only HSBC Canada can—will have an obvious competitive advantage, especially if the company's global government relations initiative pays off.

And as if Bolero were not revolutionary enough, now comes the launch of the New York-based Internet Trade Finance Exchange (ITFex). By creating a wide-open online marketplace

matching international trade opportunities with appropriate funding sources, ITFex, its competitor, London-based LTP Trade plc, and two other systems currently under development could blast any number of financial intermediaries into irrelevance.

ITFex is a computer platform that enables members to list, market, sell and bid on trade-related paper in a transparent auction that brings together hundreds of commercial banks, specialty finance houses, government export agencies and companies engaged in international trade. The auction is administered by ITFex's proprietary auction technology. Banker's Trust Company, a subsidiary of giant Deutsche Bank AG, will provide custody, clearing and settlement services for all ITFex members.

ITFex's developers boast, with good reason, that "More buyers and sellers means a more open, efficient marketplace, fairer pricing and more competition." They are too modest. By simplifying the clearing, collection and settlement process associated with trade finance, and by dramatically reducing the time and cost of maintaining global trade-finance portfolios, the system should attract whole new classes of investors. Because of the consequent boost in demand for more manageable and marketable e-paper, over the long term export finance should become vastly easier to obtain. To date, the relatively illiquid secondary market for e-export finance paper has meant buyers and sellers have had to rely on their own networks.

If or (more likely) when ITFex or a successor achieves the critical mass it needs to succeed what then happens to all the world's Boleros, Proponixes ... and Export Development Canadas? On the supply side, there won't just be more lenders than ever before; there will also be one, two, or many new micro e-export finance brokers who take it upon themselves to match borrowers, lenders and insurers from desktop computers in basement offices. Their start-up costs will be minimal, and with Banker's Trust underwriting the Exchange, these e-finance day traders will pose no systemic risk as they auction off their clients' risk or buy others' risk for their own accounts.

This global trend towards auctioning risk will not wait for Canadian policy-makers to decide whether it is a good thing. It will cause them regulatory headaches from Day One. Will e-export finance paper trade flowing across borders be subject to regulation as securities? Or will

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the focus continue to be on lenders' capital ratios? And what will be the impact of new rules from the International Accounting Standards Board, among others, to impose fair-value rules for all financial instruments, including derivatives? One way for EDC to make itself useful would be to join ITFex and/or Bolero and, as the first ECA, help discover the answers to some of these questions.

The broadening and deepening of the world's export finance markets are likely to bring about one longstanding Canadian policy goal: at least modest export diversification away from the US market. The reason is that while selling into the US almost literally couldn't be easier, an electronic environment will make selling into other countries substantially less difficult than it currently is.

Not only is the US the biggest market in the world, it is also the most creditworthy. For that reason, the majority of Canadian export deals are conducted on the simplest basis of all: current account sales, with customer payment required within 30 days of delivery. To be sure, open-account sales to the US are often backed by rudimentary forms of short-term export credit insurance. But on the whole, the US option is very tempting compared to the complexities involved in financing exports to other markets, especially in the developing world. Providing a medium-term loan to a potential buyer of heavy machinery or investing in a long-term capital project in addition to extending credit can be an extremely off-putting proposition—especially when the Canadian company has to deal with issues like fluctuating currencies, unfamiliar business practices, political instability, economic uncertainty and hard-to-gauge company balance sheets.

But the development of online export finance means the whole process of exporting worldwide is rapidly becoming vastly more transparent, hence less litigious and even less susceptible to corruption. And the inevitable emergence of an online risk auction marketplace means a company will be able to offload its individual downside exposure to firms that aggregate it with other, offsetting risks.

E-export finance also provides the technological basis for attaining another of the government's long-standing policy goals, which is "to broaden the base of participation in export financing by the Canadian financial sector." Of course, in doing so it also calls the main rationale

for EDC's existence into question.

If Canadian businesses are to take advantage of this new broader, deeper e-market, they have to be e-ready. Lots of evidence says they are not. E-export finance is an integral aspect of globalization, part of the technical toolkit Canadian companies need in order to compete. And government policy is to help speed the inevitable arrival of electronic alternatives. This may not be wise; it may be yet another case of government intervening paternalistically into matters it barely understands; but, as a creature of government, EDC has to play its part.

A logical next step for EDC would be to fold any new efforts to increase the use of e-export finance into the government's broader efforts to foster more online commerce in Canada. There are literally thousands of B2B online business exchanges in the world. Only a handful are in Canada and the only one involving export finance is the ExportSource exchange run by CCC. If EDC was serious about getting a piece of this action, the best way would be to link up with DFAIT's much larger InfoExport online exchange, then perhaps partner with a bank.

In fact, the e-finance edge EDC can add to the Canadian business mix would likely have a relatively short-term payoff in fostering Canadian e-competitiveness. Help certainly is needed. A recent study by the Canadian subsidiary of International Data Corp. revealed that, for example, the number of medium-sized (100-499 employees) businesses with supply-chain management fully integrated with their websites was approximately 15 per cent in the US compared to approximately three per cent in Canada.

The longer-term implications of new kinds of e-finance may not be entirely pleasant. In the brave new world of a truly global e-export finance market, it is not just human rights or environmental activist critics of EDC that may long for the day they had a government agency that at least tried to translate Canadian values into lending policies. Other less altruistic souls may find themselves searching for an ethically legitimate way to online-fund the extra few basis points needed to give Canadian exporters a competitive edge.

After two decades when deregulation and privatization have been in vogue, then recently not so much, the issues surrounding e-export finance have become especially urgent. Governments worldwide are pondering how or if to proceed with a new round of World Trade Organization (WTO) negotiations. If there is to

be a new round, experts agree, it will be focused on developing nations. These countries have their own views on how well the world's trade financing paradigm functions. Many are focused on the question of how e-export finance can serve to fill global gaps, by, for example, creating more efficient and therefore liquid secondary markets for higher risk paper—which is exactly where ITFex and the other exchanges would seem to fit in. Moreover, emerging markets, the ones where much of the troubled debt is issued, are likely to be the main growth engine for the trade finance sector. Last year, trade finance flows between the US and Western Europe slowed but in Eastern Europe, Latin America and Asia, activity grew by 15 per cent, according to a report by Celent Communications. EDC could use e-tools to relatively safely increase both its own and Canadian industries' presence in these markets.

To date, EDC has often been damned for concentrating excessively on conventional markets that could be served equally well by the private sector. Soon e-export finance will make these markets even more liquid. EDC can make up for its past sins, including cherry-picking choice clients from the banks, by fostering a new kind of Canadian e-partnership with DFAIT, the banks, logistics companies and exporters.

It should at least take a flier on new e-export finance alternatives that will help Canadian companies access developing markets. There are obvi-

ous drawbacks to doing so, of course: that is where many a new flagrant and foul environmental and human rights dragon lies awaiting—not to mention the digital Chernobyl some experts say is the Internet's inevitable destiny. And as if that weren't enough, there is the possibility of a new debt crisis, perhaps led by Argentina, emerging just in time to make a mockery of all these new efforts to squeeze more value for borrowers by narrowing spreads through increased competition on the new e-secondary markets.

But, despite its risks, the developing world will offer ample profit opportunities over the next few decades. And besides, the perils it faces are one of the things that makes EDC-watching so unfailingly interesting. It will be even more so now that the Corporation gets serious and tries to come from behind in its race against disintermediation. The federal government's Team Canada Inc. has no fewer than 23 departments and agencies claiming they have a key role to play on developing the country's exports. But only EDC is the real deal when it comes to trade finance. All 23 have e-agendas of one sort or another; every creature of the federal government does. None will fulfill its full potential unless EDC can buy, negotiate, innovate and do whatever else is necessary to bull its way to the top of the e-hill.

David Clarke is an Ottawa-based communications consultant who has written about e-trade finance for publications including Trade and Forfeiting Review, Global Custodian and Wired.

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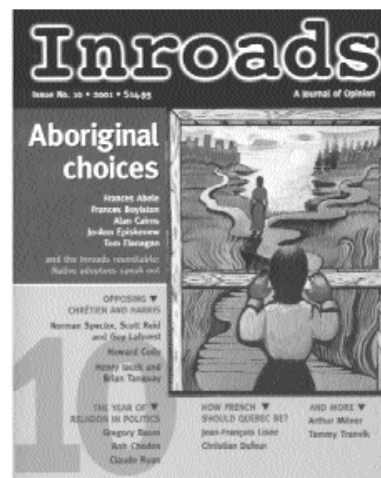
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