SUBMISSION FROM THE RECEIVABLES INSURANCE ASSOCIATION OF CANADA IN RESPONSE TO THE CONSULTATION DOCUMENT ENTITLED "SUPPORTING A STRONG AND GROWING ECONOMY: POSITIONING CANADA'S FINANCIAL SECTOR FOR THE FUTURE"

Questions for Consultation

1) What are your views on the trends and challenges identified in this paper? Are there other trends or challenges that you expect to significantly influence the Financial Sector going forward?

Executive Summary:

The Receivables Insurance Association of Canada (RIAC) comments on three trends/challenges that will significantly influence the Financial Sector going forward. These are macroeconomic, increased concentration, and internationalization:

- **From a macroeconomic perspective, historically low interest rates are weakening the creditworthiness of Canadian businesses.**
- **Concentration in the Financial Sector, along with the accompanying stringent regulatory environment, is resulting in a trend of non-bank lending (factors, Fintech) that are less regulated and, as such, can potentially bring innovation to the market.**
- **As Canadian banks expand internationally, they can face daunting credit risks that can be supported by other international companies operating in Canada, such as credit insurers, who can assist them in mitigating international credit risks.**

Representing the credit insurance industry, RIAC comments on how credit insurance integrates with Canadian businesses and financial institutions and the Financial Sector in general.

Response:

The Credit Insurance Landscape

When a company sells their product to another company on credit terms (take now and pay later), the selling company purchases credit insurance to protect against the possibility that the purchasing company will not be able to pay the seller when the payment becomes due. Credit insurance mitigates credit risk and provides banks and borrowers with the confidence to continue offering credit to Canadian companies that are effectively the heart of our economy. Export credit insurance is the insurance of trade receivables that are generated from exports. Comprehensive credit insurance is the insurance of trade receivables irrespective of whether they are generated from export or domestic transactions.

Canadian companies are able to utilize credit insurance in a number of ways to strengthen their businesses. They are able to reduce financial risk by converting bad debts into claim payments, thereby conserving the value of their assets. They are also able to improve their cash flow by enhancing their accounts receivable, which encourages banks to increase their working capital loans. Credit insurance is particularly useful for SMEs who do not have the resources to self-insure, to aggressively pursue bad debt collection when companies fail to pay them or to pre-screen a potential customer's creditworthiness.

With the challenges currently facing the economy, Canadian companies are very likely to become less creditworthy. This will result in the contraction of credit by banks, and in turn by borrowers to their customers as the safety of trade receivable payments weakens, impacting the growth potential of Canadian businesses. This was very evident in the last recession when the government, in an effort to stave off further credit contraction, and in recognition of the value of credit insurance, approached private sector credit insurers to contribute stability to the financial system by providing more credit insurance through assistance from Export Development Canada.

In the Canadian credit insurance market, the following table shows the current participating underwriters, all of which, except Export Development Canada, provide comprehensive credit insurance policies. Importantly, the comprehensive credit insurers all offer export credit insurance, although each with a different value proposition. All comprehensive credit insurers are multinationals and potentially facilitate the internationalization of other Canadian financial institutions. In addition all are tightly monitored by the Office of the Superintendent of Financial Institutions and by their provincial counterparts.

UNDERWRITER	SHARE OF THE CANADIAN MARKET	UNDERWRITER	SHARE OF THE CANADIAN MARKET
Export Development Canada	47.6%	AIG Property Casualty	5.7%
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Atradius Credit Insurance	6.5%	Zurich Insurance Group	.5%

Trends and Challenges:

Macroeconomic

The low interest rate only impacts credit insurance in that they perhaps allow some companies to survive longer than they would in times when rates are closer to historic norms and hence reduce the number of claims. The corollary to that is that when interest rates do climb, there will be a spike in claims. Those that are not protected by credit insurance when that time comes will face economic hardship as their customers will not be able to pay them. This will then extend to banks who have not insisted that their borrowers take credit insurance because the collateral that they have used to protect their loans (accounts receivable) will evaporate as those companies go bankrupt.

While credit insurance does not insure consumer debt, the highly leveraged consumer will impact retail sales when interest rates rise which will result in financial distress for retailers which will then domino back through wholesalers to manufacturers to raw material producers.

Unfortunately an interest rate rise is inevitable and so this is not something that can be avoided. As implied above, one mitigating solution would be for businesses to credit insure and for banks to insist on credit insurance for both bad debt protection and for the business guidance that credit insurers provide to their clients through the assessment of their clients' customers.

Increased Concentration

Increased concentration is a natural outcome. Consolidation is required to improve the efficiency of capital, especially in highly regulated industries such as banking and insurance. Consolidation results in more complex organizations which in turn leads to more regulation as responsible parties attempt to understand and minimize risks. Increased regulation increases the burden on regulated companies (typically both capital and reporting requirements) thereby discouraging new entrants – both start-ups and established foreign competition. Startups in these sectors face mammoth competitors that have already achieved capital of economies of scale. Large foreign competition may be daunted by the amount of regulatory environment and the size of the capital requirements for what is a relatively small market that is already competitively serviced.

Looking into the future, from a credit insurance point of view, the trend may be towards non-bank solutions to business lending. An example is factoring as businesses sell receivables in order obtain the working capital required to grow. Typically factors are not regulated and therefore do not have the administrative burden or any capital requirements. Factors do recognize the risk posed by weaker companies and many do credit insure or insist that their clients credit insure in order to protect their capital. Those that do credit insure are less likely to face financial distress thereby adding to the stability of this sample solution that avoids the regulators.

Fintechs seem to be currently focused on the consumer but as they evolve, it seems inevitable that they will progress to the SME end of the business spectrum bringing innovation to the financing of that market sector. If this is the case and fintech regulation does not evolve as quickly, those that are credit insured will, in effect, undertake risks that are monitored by a regulated entity thereby adding stability to the market. It is important that capital requirements and regulation do not choke the innovation that fintechs can bring and that fintechs be an avenue for competition within the financial market that is otherwise not attractive to new competitors.

Internationalization

Like concentration, internationalization is a natural outcome, especially in the financial world. Proper financial management dictates spread of risk and in order to achieve this, financial institutions and insurance companies look outside their national borders. In the credit insurance industry, this was particularly true as businesses of all sorts globalized with the requirement to insure foreign receivables which required feet on the ground in the markets to which the policyholders sell in order to properly assess the risk. In the last 25 years the credit insurance industry was distilled from a diverse group of tens of insurers to over 85% of the worldwide market being insured by just 3 companies who are all located around the world.

With their internationalization, credit insurers are well placed to assist banks in their quest to expand in that they can assist those banks in protecting their borrowers from foreign unknown (to the borrower and bank) risks thereby adding stability and utility.

Internationalization suggests a need to take into account the regulatory bodies in other countries to add efficiencies to the regulatory process.

2) How well does the Financial Sector framework currently balance trade-offs between the three core policy objectives of stability, efficiency and utility?

Executive Summary:
The current regulatory framework:
a) hampers efficiency due to the number of regulators;
b) reduces competition:
and,
c) impedes innovation.

Response:

From a credit insurance point of view, the efficiency is hampered by the number of regulators. There is diminishing returns with each additional level of regulation While it is recognized that regulation certainly adds to the stability of the Financial Sector framework, the over-regulation of the industry (OSFI plus provincial regulators, not to mention regulators in every other jurisdiction in which the insurer is licensed to operate) as mentioned previously can contribute to reduced competition by intimidating new entrants. It certainly leads to productivity being impeded as focus is directed away from innovation and product development towards satisfying reporting requirements. A harmonization of insurance acts and regulators across Canada could lead to a robust centralized regulatory agency would add significantly to the efficiency.

With respect to regulators in foreign jurisdictions, internationalization has the natural outcome of cross-jurisdictional regulation. The aforementioned centralized regulatory structure could prove to have additional teeth because of their ability to reach abroad to other regulators in a unified voice to coordinate actions. The latter should add to the stability of the framework.

The utility of the Financial Sector framework is hampered by the lack of competition. However, any actions taken to encourage competition needs to be balanced against the limitations/restrictions imposed on existing participants of the industry so that they are not disadvantaged. This becomes quite complex as the economies of scale of capital and internationalization arising from the need for spread of risk are introduced. A government initiative to promote competition and innovation would be welcomed.

3) Are there lessons that could be learned from other jurisdictions to inform how to address emerging trends and challenges?

Executive Summary:

Other jurisdictions can provide a useful backdrop into the aforementioned challenges facing the Financial Sector. In particular, international firms such as credit insurers could provide specific information on how regulations in other economies can be useful to the Canadian Government for local issues.

Response:

All credit insurers in Canada are multinationals. They operate in numerous economies and how they deal with emerging trends and challenges varies according to local economies, customs and laws.

Generally, individual country organizations of credit insurers will receive direction from centralized senior management and then the implementation of processes to deal with the trend/challenge are carried out locally. Accordingly, to generally respond to how to address emerging trends and challenges is unlikely to produce functional information. However, if the question was directed towards a specific trend or challenge, the insurers could be polled as to what their preferences would be in terms of the best practices approach to solve the issue. Confidential information provided to Canada by each insurer with respect to actions taken other jurisdictions could then be distilled into an efficient process to be implemented in Canada.

The greatest challenge to this suggestion is the length of time it would take to amass information and then for the resulting action to be formulated and enacted into law/regulation. If the governing body is agile and focused, it is more likely that effectiveness of this approach will be useful and implementable.

4) What actions could be taken to strengthen the Financial Sector framework and promote economic growth, including with respect to the identified themes? How should those actions be prioritized?

Executive Summary:

RIAC believes that current Bank Act regulations restrict SMEs in Canada from gaining access to working capital to assist them in growing both domestically and internationally. A simple change to the Regulations would provide SMEs in Canada with the access to working capital that they need, would not require public funds and coordinates with the Department of Finances Canada's themes.

Response:

The Canadian credit insurance industry plays a vital role in protecting Canadian business from catastrophic loss in the event of the failure of one or more key customers to pay their bills. In 2015, the credit insurance members of the RIAC paid over a quarter of a billion dollars in claims to thousands of companies, most of them small and medium sized. In several cases, these payments kept viable businesses in operation, saving them from insolvency and protecting good paying, middle-class jobs. Our credit insurance products give Canadian businesses the confidence to approach new customers, or continue serving old ones that are in temporary difficulty. These products also protect a company's balance sheet, allowing it easier access to critical working capital lines of credit from banks.

However, while Canada has a vibrant private sector credit insurance industry, it is significantly smaller as a portion of Canada's economy than in other major developed economies. Growth of the sector, and a competitive marketplace, is hampered by an unintended consequence of the regulations of the Bank Act, which effectively force Canadian banks to refer their customers to EDC, a Canadian government owned credit insurer. RIAC has determined that a small amendment to the regulations governing the Bank Act would allow Canadian banks to refer customers to any viable Canadian private sector provider of receivables insurance. EDC supports this regulatory change.

Making such a change would make a small, but tangible, contribution to a more vibrant private sector credit insurance industry in Canada, freeing it to grow closer to the levels seen in other developed economies, increasing competition and choice and, by extension, increasing the number of Canadian companies seeking credit insurance and therefore being in a position to take the risk necessary for growth, both domestic and export.

A full explanation of the regulatory issue is attached as Schedule A.

SCHEDULE A TO THE SUBMISSION FROM THE RECEIVABLES INSURANCE ASSOCIATION OF CANADA IN RESPONSE TO THE CONSULTATION DOCUMENT ENTITLED "SUPPORTING A STRONG AND GROWING ECONOMY: POSITIONING CANADA'S FINANCIAL SECTOR FOR THE FUTURE"

This submission addresses the Bank Act; specifically, the the "Insurance Business (Banks and Bank Holding Companies) Regulations". A simple amendment to a Bank Act Regulation can, almost immediately and at no cost to the federal treasury:

1) ***enable small and medium sized businesses, and lending institutions through collateral security enhancement, to reduce their financial risk in challenging economic times (stability);***
2) ***allow the largest influencer (lending institutions) of the purchase of Accounts Receivable Insurance (Credit Insurance) to refer their clients to many providers of credit insurance rather than just to Export Development Canada (competition and the associated efficiencies including innovation) and thereby strengthen this component of the financial market infrastructure; and***
3) ***Increase the borrowing base of Canadian businesses thereby providing them with more working capital to invest in growing their businesses and the number of Canadians that they employ (utility).***

<u>The Credit Insurance Landscape</u>

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The *Bank Act* Restriction

Canadian companies are constrained by a *Bank Act* regulation that states that only "export credit insurance" is considered an "authorized type of insurance." As a result, banks cannot direct their customers to credit insurers if the company's business is domestic. Given that Canada's GDP is 70% domestic, this constraint has a significant impact on the ability of domestic-facing Canadian SMEs to grow.

In fact, a recent ruling from the Office of the Superintendent of Financial Institutions (No. 2016-01) has stated that banks may not promote comprehensive credit insurance and may only promote export credit insurance policies. Since Export Development Canada is the only credit insurance underwriter that provides only export credit insurance, de facto, according to the current legislation, banks may only promote insurance from this Crown Corporation.

SMEs generally tend to develop domestic business first. If successful, these companies leverage that experience to pursue export opportunities. However, many will not reach the export stage if they are not provided the best support possible to first grow domestically. SMEs would benefit significantly from credit insurance to help with growth, but the regulation under the Bank Act skews that market by introducing the following biases :

1) Companies focused on domestic trade in other OECD countries do not face the same hurdle of accessing credit insurance thereby giving foreign companies a significant advantage;
2) Canadian companies that engage in exports are often made aware of the value of credit insurance by their bank, whereas companies focused on the domestic market are not made aware of how their financial profile might benefit from comprehensive credit insurance with the result that SME's growth can be stunted: and,

3) SMEs will be denied access through their banks of the ancillary benefits of comprehensive credit insurance including industry expertise, collections, the sophistication of credit granting procedures (including checks on terrorist financing and money laundering schemes) amongst other financial literacy benefits.

Micro-economic Benefits

Reduced Financial Risk	Improved Cash Flow	Support Credit Management	Improved Sales
Protection against bad debt losses and export credit risk Protection against excess concentrations Bad debt losses converted to cash flow	Maximized borrowing power Additional working capital Enhanced earnings by reducing bad debt reserves	Credit procedures are enhanced and positioned for evolution into a larger company Access to highly specialized industry/sector expertise Objective back-up opinion for credit decisions	Safely increased open credit sales Existing/potential client relations improved through better sales terms Reduced need for letters of credit Safe expansion into new and emerging markets

The Change Requested

All that is required to rectify this situation is to strike the word "export" from section 2(f) of SOR/92-330. This simple regulatory change can be implemented immediately by the federal government at no cost to the public. As banks and credit insurance companies already have the services in place, Canadian SMEs could benefit from the economic impact of this change immediately. The Receivables Insurance Association of Canada (RIAC) stands ready to support implementation of this change that can benefit so many Canadian companies.

About the Receivables Insurance Association of Canada

RIAC is an association of people and businesses that are interested in the promotion of Receivables Insurance and all aspects of the products to the Canadian business community. RIAC is invested in educating companies, banks and other third party influencers of the breadth and scope of the industry in Canada and the value of the benefits of the products and services offered by the industry. RIAC does not in any way promote one member's products over another and is focused on growing the industry as a whole. Our member companies represent over 85% of the global credit insurance marketplace. Export Development Canada is an important member of RIAC but, in its capacity as a crown corporation, has recused itself from and has declined comment on this public policy advocacy.

All or any part of this submission from the Receivables Insurance Association of Canada may be made public but in so doing, Export Development Canada's recusation must be cited.