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EDC Review 2018
Global Affairs Canada
Attention: Diana Smallridge
Team Leader, Review

To Whom It May Concern:

I am writing to provide some insight which I hope will assist the Government of Canada in its review and modernization of Export Development Canada (EDC). In my opinion, this government review of EDC's role, functions and policies are both overdue and very timely. I am pleased to offer this and any further insights and suggestions that might be helpful. While the views expressed incorporate some of the experience of my employer, S2e Technologies Inc., the views expressed are based on my 30 years of experience at Canadian and International banks, private sector employers and transactions involving EDC.

While there are a lot of excellent things about EDC that I could mention – particularly around the quality and integrity of their Advisors who are willing and able to meet with clients at the workplace – the purpose of this letter is to assist in the understanding of things that are not working and need improvement. So while the tone may be sharper than what may be typically submitted in support of such a review, my intention is focused on helping you understand these improvement needs and is not necessarily intended to be interpreted to be overly critical of EDC.

Overall, the reader should take away from this letter that while EDC has to potential to significantly assist Small and Medium Sized enterprises (individually "SME" and collectively "SMEs") to take advantage of the various trade agreements that the Canadian government has painstakingly negotiated, it has been my experience (highlighted later), that EDC's impact in this respect has been and continues to be far below its potential.

While some have argued that the status quo is good enough and that changes are not needed, a nuanced look at the facts indicates otherwise. As the CFO of an internationally focused green technology and project development company based just outside of Waterloo Ontario, it is my view that while the status quo may work for large corporate exporters (notwithstanding the numerous ethical issues that many have found themselves embroiled in partnership with EDC), the status quo is not working for SMEs. Supporting my view is the publicized lack increase of export activity following the implementation of major trade agreements. SMEs simply are not able to take advantage of these agreements to their potential because the barriers remain substantial. For SMEs, it is far easier to simply import goods and services produced in foreign markets than to export and finance the associated working capital.

Before I delve into specific issues, I would like to give some context in terms of my perspective. As you will see below, I have had decades of experience dealing with multiple products and departments within EDC under varying economic circumstances. This included working directly with EDC officers structuring syndicated credits for automotive and other corporate credit relationships before, during and after the 2008/09 Credit Crisis.

In my 30+ years of work experience, I have collaborated and done transactions with EDC from the perspective of Schedule A banks, Schedule B foreign bank subsidiaries and Schedule C foreign bank branches operating in Canada as well as a business entrepreneur seeking export related support for companies that I either acted as a financial consultant or I was part of the executive team. During my career, I have been: a small business banker; mid-corp commercial banker; international corporate banker and asset-based lender, large corporate banker; Commercial work-out officer; Head of Risk Management; advisor to small businesses: an executive in a private sector small and medium-sized finance boutique: a small business owner; and, currently, the CFO of a Waterloo-area green technology company. This has provided me with a unique perspective on EDC's role in supporting Canadian business.

At one point, EDC even reached out to me and brought me to Ottawa to be interviewed as a potential candidate to lead their Toronto Office.

My experience with EDC included files/clients and some very interesting initiatives such as (i) establishing the EDC – Cdn Bank joint venture "Northstar Trade Finance"; (ii) implementing one of the first clients for EDC's foreign exchange facility guarantee program; (iii) implementing, administering and collecting numerous files where EDCs provided credit insurance – both on international clients and through its partnership on domestic clients; (iv) offering and administering corporate credit facilities in partnership with EDC in various large, corporate-bank-syndicated financings; (v) working in partnership with EDC on collection files – both submitting claims on EDC's loan guarantee program and enforcing security through the court system; (vi) seeking and recommending corporate and trade credit guarantees; (vii) working with and establishing EDC credit enhancements needed to support credit granted to Indigenous businesses; and, most recently (vii) working through EDC's processes as an applicant in support of green/clean technology exported development projects.

Reflecting on the outcome of this experience, I am of the view that, except for some very specific situations, or for very conventional manufacturers, EDC's more valuable suite of products and services are not generally available to SME. The ones that are most commonly offered, such as account receivable credit insurance, are potentially dangerous and should be sold and used very carefully. It seems to me that since the Credit Crisis, that EDC has largely shifted its focus away from supporting domestically-owned SMEs and towards becoming a profit-generating organization that obtains an increasing amount of its fees and revenues from larger Corporate transactions – without consideration of whether these are foreign subsidiaries or result in any sustainable intellectual property being created in Canada.

This was not always the case. Historically (and especially in comparison with Ex-Im Bank of the US), EDC has had a very good reputation of creating innovative products and services that could help Canadian industry. This innovation reflected the OSFI-enforced restricted banking market in Canada by helping commercial clients obtain financing by reducing perceived credit risks as assessed by commercial banks in Canada. My experience at foreign banks operating in Canada was that the availability of this support was preferentially available to Canadian banks and their clients as it was not nearly as available to Canadian clients of foreign banks (whether Schedule B subsidiaries or Foreign Bank Branches.)

With that said, I was particularly impressed with how EDC stepped forward to offset a dramatic retraction in credit availability that occurred during the 2007/2008/2009 credit crisis. I mention 2007 because Canada had a little-reported national credit crisis caused by the collapse of the Domestic Asset Back Commercial Paper (ABCP) market. This credit crisis had the potential to have a similarly tragic impact on the Canadian economy as the 2008 US credit crisis since the Schedule 1 Banks were unable to honour their ABCP liquidity commitments. From my then-perspective as an executive working at the Canadian operations of a US bank, Canada avoided a major credit crisis in large measure because at the time American banks were very liquid and were able to provide liquidity to offset the retraction in the domestic credit markets.

Regardless of EDC's history of innovation, as a CFO in a globally-focused SME that operates in the green technology & cleantech sectors, we have found that EDC's utility to be unfortunately very limited. EDC seems to have shifted its focus away from supporting SMEs in favour of perceived "low risk" and politically visible large corporate transactions that can generate efficiently generate EDC profits to be remitted to the Federal Treasury.

Additionally, EDC's ability to support innovative businesses also seems to be restricted in an increasingly obsolete or limited view of the kind of business and industry that it can/should support. Value generated by conventional manufacturing and extraction activities are increasingly being replaced by value generated by monetization of intellectual property, "know-how" and service activities.

During my work-out experience, I noted that EDC seems to be increasingly at the centre of multiple conflictual situations. These situations occur when EDC is taking risk or providing services for both sides of a commercial dispute.

Largely because of such circumstances, my experience with accounts receivable insurance is such that I no longer recommend this product and for those who are relying upon it, I routinely caution entrepreneurs from relying too much upon this product. I think that EDC oversells the value of credit receivable insurance, which in my view quite frankly does a real disservice to Canadian entrepreneurs[1].

In the following paragraphs, I will further explain the thoughts outlined above by identifying aspects where I believe EDC is needs to improve to if they are to adequately support Canadian SMEs.

1. <u>EDC is struggling to effectively recognize and supporting new and emerging business models</u>

   As I noted above, EDC seems to be promoting policies that support an older and increasingly obsolete/limited view of business. In this 1970/1980 view, products were manufactured in Canada, employed predominantly unionized labour and exported under a variety of trade finance credit product (letters of credit, letters of guarantee etc). The EDC assistance typically

[1] I hasten to add, that I am not suggesting that EDC sales approach is any worse than that of other credit receivable insurance providers. Rather as a government agency with a mandate to help entrepreneurs export in a commercially safe way, EDC representations are typically accepted with less scrutiny than those of commercial credit insurance providers.

provided to the exporter was intended to enable them to offer more competitive terms to the foreign buyer/importer by eliminating the need for their issuance of a letter of credit.

This approach can still work well for the declining number of traditional manufacturing operations or exporters of domestically fabricated or extracted goods. However, even in such cases, the approach can struggles with the changes caused by global supply chains where much of the end product activity might be provided through the importation of sub-components. .

For example, the value created in some of the most valuable companies in the world - companies such as Apple, Alphabet and McDonald's, just to name a few, the majority of the value is created by the design and ownership of Intellectual Property - branding, patents, process and design, know-how, etc. The majority of this value accrues to the home country even when the majority of manufacturing is performed in other markets. Relatively speaking, manufacturing products or components is not the source of value creation for the entity. In fact, policies such as some of those promoted by EDC, which understandably attempts to retain high-cost manufacturing operations in Canada or may require higher cost domestic sourcing of subcomponents, can in fact contribute to a deterioration of a company's global competitiveness.

In terms of job creation, recent advances in robotics, automation and artificial intelligence are expected to ensure that the value (and jobs) generated in the manufacturing process will likely continue to be a decreasing proportion of the overall value of any given product or service.

Recognizing this trend, Canadian business has shifted away from traditional export-style manufacturing of products towards one that increasingly incorporates services, project management in foreign locations using Canadian know-how and expertise, or the monetization of intellectual property rights. Addressing the needs of such companies has been a real challenge for EDC.

A first-hand example of EDC's struggle and inability to support non-goods producing exporting SME happened to the company I currently work in, S2e Technologies Inc. A couple of years ago, S2e was seeking EDC support to develop several green technology projects in Argentina. We had formed a consortium of Canadian and local service providers as a means to optimize the project benefits and reduce project risks. There were opportunities such as credit guarantees and loans, bid and construction bonds and foreign exchange guarantees. We were in direct competition with other developers, primarily European, that had the active support of their national or other supranational development banks and export credit agencies.

The response from EDC, which was decidedly negative, seemed to convey a view that SMEs should not be attempting to play a role in international projects that are typically the preserve of large corporate public companies. The initial reason EDC gave for declining to consider was that they are not taking any risk exposure to Argentina. This response was inconsistent with their subsequent public announcements on their website of large approvals and funding for projects in Argentina by both SNC Lavalin (under sanctions for bribery in foreign markets) and GE Canada (a Canadian subsidiary of a large US public company). As large public companies, both SNC Lavalin and GE Canada had ready access to capital markets for their projects, so EDC support was not likely as critical for these projects as it was to S2e's.

When this inconsistency was raised to EDC, another explanation provided was that EDC was predisposed to multinational companies with extensive overseas experience, even if foreign owned, and not really able to support technology developers that were not exporting a "tangible product manufactured in Canada." This again was inconsistent with another project whereby EDC provided direct credit support to a project that another excellent company, Canadian Solar Inc., had in the Middle East and where they used solar panels manufactured by the company in China. This fluctuating reasoning was particularly frustrating for S2e since Canadian Solar was our anticipated solar panel provider and co-developer in the Argentina project and that our principals were formerly executives at Canadian Solar responsible for developing its international project business. It seemed to us that as a matter of internal policy, large public companies had a more favourable reception within EDCs adjudication processes.

2. <u>EDC Loan support and Credit Guarantees are skewed towards large business transactions</u>

Direct EDC loan funding is limited to transactions whereby direct EDC loan commitments are a minimum of $10 million. Since pursuant to this program EDC must partner with a Canadian bank on this transaction who is also providing financing, this direct EDC lending programme is clearly not a service that is available to SMEs. However, the risk exposure incurred EDC through this lending can adversely affect available support for SMEs by virtue of these large loans consuming a significant portion of EDC's market or counterparty risk appetite.

For smaller transactions and in lieu of direct lending, EDC attempts to address this deficiency by making available a partial loan guarantee to a bank. In this respect they are intentionally "piggy-backing" on the same credit standards of a Canadian bank and taking a proportionately identical risk exposure while earning revenue for the EDC guarantee. While in theory this sounds like a reasonable solution, in practice it is quite limited and is likely not widely used.

The reason for this dichotomy is easy to understand if one looks at things from the perspective of a Canadian bank. If the credit standards, documentation, processes and risks are the same as those of the Canadian bank, and given that EDC requires a Canadian Bank to fund and administer all aspects of the loan (but adds additional documentation, coordination and administration work for that bank), there is an strong incentive for the bank to avoid all of this by simply taking over the entire transaction. EDC support is thus more theoretical than practical, as it has limited value or is useful only in the circumstances whereby the the Canadian bank at a credit cap (typically not the case for SMEs) or otherwise chooses to reduce its credit exposure. For a bank that is reducing its credit exposure, the credit support typically displaces risk already assumed by the bank and thus is more of a benefit to the bank than for the SME.

Rather than "piggy-backing" on the Canadian bank's credit adjudication and administration processes, the more practical approach would be for EDC to develop products and services that it directly administers independently – much like Business Development Bank Canada (BDC)

3. <u>EDC Credit Insurance is over-sold and can be a risky product for many SMEs</u>

Unlike than loans or loan guarantees more typically used by larger corporate entities, the primary support that EDC provides to SMEs is the well-known accounts receivable credit insurance product. This product is sold to entrepreneurs based on the premise that since the risk is being shifted from the exporter to EDC, the exporting SME can price more aggressively in its bids, ship more orders, take on larger orders, take on more foreign counterparty risk and reduce/eliminate the need for Foreign Buyer letters of credit and bank guarantees. EDC has worked with Canadian banks so that they will support this product sales approach by being willing to offer higher amounts of financing on such EDC insured receivables.

This sales approach is risky for the SME, and the truth is that more than one Canadian business has failed because of misunderstandings and administration challenges associated with these policies. Firstly, the compliance requirements of these credit insurance policies are very complicated and difficult for a small business owner to administer. Failure to comply with time sensitive administrative and notice requirements details generally enables the insurer (EDC) to disavow coverage on any loss subsequently claimed.

To make matters worse, the policy allows for "exclusion against loss subject to/caused by a dispute." While this exclusion is understandable in the case of the shipment of a defective good, the reality is that the nature of the dispute is only limited by the imagination and creativity of the party that is seeking to avoid, delay or negotiate payment. In such cases, it has been my experience that EDC will generally cite such clause as a means to defer or even advance a portion of, any submitted claims until the dispute is fully and completely resolved. Of note, resolution in these cases often comes from arbitration, mediation or court orders, which can take years and given the cash impact on the business puts the exporter at a distinct disadvantage in the dispute resolution.

While this goes on, the bank that has provided the receivable financing to the Canadian exporter will immediately remove the "EDC Insured" receivable from its list of ***eligible*** receivables and will cease providing any financing and revoke any financing already extended on this receivable. (Banks exclude receivables that are "subject to dispute" from the receivables that it uses to calculate the borrowing base to support a loan.)

As a result, the exporter could have a large receivable – financed with a higher proportion of bank debt – immediately deemed unfinanceable for an indeterminate period. This can cause significant unexpected retraction in working capital for that exporter, and I am personally aware of a number of circumstances where scenarios like this caused major retractions in the company's operation, and even significantly contributed to the failure of the business.

Worse still, I believe that in some cases the foreign buyer was happy to assist the Canadian exporter to gorge on EDC credit-insured bank debt knowing that he would gain significant negotiating leverage by threatening to claim (or actually claiming) a dispute as a means to defer/negotiate payment. Canadian entrepreneurs that are not seduced by an over reliance on the existence of an export credit insurance safety net generally don't allow themselves to become so over-exposed.

4. EDC is increasingly becoming entangled in conflictual situations where SMEs are sacrificed for the larger relationship

This has been the case especially in industries such as the automotive sector, which EDC's support has been particularly innovative. In such cases, the agency will provide insurance to sub-suppliers even when their customer is Canadian (not an export). They are able to do this because EDC recognizes that the overall component (the vehicle) is largely exported with a threshold amount of deemed Canadian content so credit insurance is available individually to all participants in the domestic supply chain.

Clearly, if there is an issue (for example a quality issue at the integrated exported component level), the car company (Original Equipment Manufacturer or "OEM") will chargeback or refuse payment on that order until the part is reworked or replaced. In such situations, it is not common that the component supplier to the OEM (Tier 1 supplier) will allocate some of the rework cost or chargebacks to some or all the sub-component suppliers. This cost allocation could occur even when the sub-component supplier's work has no relation to the underlying quality issue on the component.

In such a circumstance, the small subcomponent supplier (Tier 2 or 3) is now forced to either accept what is deemed to be an unfair chargeback or dispute it. If that supplier disputes it, then given the borrowing base definition it's bank will immediately reduce the supplier's credit availability (in some cases all unrelated receivables from that Tier 1 supplier) and any corresponding EDC receivable insurance claim will be deferred until the dispute is fully resolved. Furthermore, upon learning of the dispute, EDC account officers may reach out to the Tier 1 component manufacturer to discuss the claim without the knowledge or presence of the Tier 2 supplier that submits the claim. Since the Tier 2 supplier is generally smaller, far weaker financially and more concentrated in its sales, the Tier 2 supplier should expect his interest to be sacrificed within EDC in favour of the larger EDC relationship with the Tier 1.

Given the pervasiveness of EDC in the business community, I have had personal knowledge of at least one situation whereby a law firm was asked to pursue a claim under the EDC insurance policy, which created a situation whereby that law firm was both representing both EDC on one matter while representing a SME trying to press a claim with EDC under its credit insurance policy. Despite a considerable investment by the SME to pursue the claim, in the view of the entrepreneur its interests were not seriously advanced by the law firm resulting in a serious impact on the underlying SME.

Rather than using "dispute" as a common reason to indefinitely defer potential credit insurance payment obligations, while at the same time relying on the court process to arbitrate settlement, in my view EDC should explore using a separate process to expedite claim payments. Such a process (even if it provides for a partial and recoupable advance) could significantly alleviate the financial pressure on the SME while the court claim continues. In such a process, EDC could use expedited independent arbitration proceedings for purposes of processing any insurance claims, rather than waiting until final completion of prolonged and expensive court or international arbitration proceedings and all associated appeal options, as is the current practice.

Under such circumstances, EDC could make advances or partial payments, which could ultimately be made even though the EDC client failed to obtain a favourable court or arbitrary decision. To protect against fraud, advances could be made on a recoupable basis. Even if ultimately deemed uncollectable, any amount written off by EDC will generally be taxable income to the client, so the overall impact on the public purse is muted.

Additionally, if EDC finds itself in the middle of a dispute between two of its customers, there needs to be a special internal process to administer the relationships. The EDC officers involved should be different than the people who handle the relationships on a day-to-day basis. This way, EDC can provide assistance to the respective clients without being concerned about the relative value of these individual relationships.

5. <u>EDC needs to create financial products to support project developers and businesses who are developing and monetizing intangible Intellectual Property rights</u>

   Companies that have “know-how” to take critical roles in international projects or develop intellectual property that are of interest to foreign buyers will drive the innovation that will propel future Canadian jobs, industry and tax revenue. In my view, EDC’s current ability and product offering to support such business models are very limited.

   For example, as a developer of international projects, the company that I work for would normally establish a local Special Purpose Vehicle (“SPV”) – a legal entity to execute and perform the project. This structure is critical as it serves as a way to compartmentalize the project for tax compliance and risk, financing and litigation. Most countries, including Canada, have very complex and punitively-interpreted “Permanent Establishment” rules that, if not very carefully complied with, provide an opportunity to tax the extraterritorial revenues and activities of an exporter. The common solution in international projects is to use a local development SPV.

   In the EDC model, this SPV is typically assessed as foreign entity and is thus ineligible for financial support. EDC’s value is thus limited for supporting the development of international projects. Contracts and receivables from the Canadian parent entity to this SPV are seen as related and are similarly generally ineligible for support.

   Similarly, since much of the goods and labour being used in the foreign project may be procured locally (for example in terms of construction), the integration or design/intellectual or management aspects of such foreign projects may be the primary service that is being provided. From an overall monetary value, this may be a small component of the project. However, from a holistic point of view, and taking into account development to Canada’s innovative economy and ability to replicate in other projects/markets, integration knowledge can be the “secret sauce” and may have far more long-term value.

6. <u>Lack of Integration with Canadian Commercial Corporation</u>

   Canadian Commercial Corporation (CCC) is a sister Crown Corporation that is specifically established to help Canadian companies secure and administer foreign contracts. Unfortunately, lacking a budget comparable to EDC’s, CCC does not have the same visibility or public awareness. This is unfortunate, particularly since CCC’s focus on projects and “innovative know-how” is more in alignment with where the economy is going.

   Regardless, CCC does not underwrite export risk; EDC does. One would expect that EDC would have a dedicated team within CCC to specifically assist the latter’s clients and projects in de-risking and financing their contracts. As it happens, not only does that not seem to be the case, but the public perception is actually that the two agencies struggle to work together and that a company should choose one or the other. This needs to be fixed for Canada's export sector to be able to flourish.

7. Prioritization of EDC support for SMEs over that for Large Corporate interests

   This is a tough issue, but important nonetheless. Public companies have access to capital markets and financing sources that SMEs do not. SMEs are heavily reliant on credit support from Canadian banks and Business Development Bank and their ability to consummate a transaction or undertake a project is often exclusively determined upon whether the bank is willing to extend financing.

   It should be unacceptable for EDC to decline a risk underwriting request from a SME due to the fact that the EDC risk appetite has been previously used to support commitments for Large Corporate requests. Our experience in Argentina suggests that this does happen.

   I believe that risk appetites and limits at EDC should be established separately for SMEs and Large Corporations. In other words, the counterparty risk exposure created by EDC credit support approvals for SMEs would not be a variable of or combined with EDC's support to Large Corporate/public entities. EDC currently maintains separate counterparty risk limits with its Canada account for politically directed risk support programs, so the agency should be well versed with procedures to separately administer counterparty risk limits.

   In conclusion, I hope that this letter contains information that can be useful to the current review of EDC. The agency has in the past provided a valuable service to Canadian businesses and the economy at reasonable risk to the public purse. I believe and am hopeful that it can do so again. As a trading economy that needs to foster and monetize intellectual property and services where SME's can grow extraordinarily quickly if the ground is properly cultivated, we need find a way to make EDC part of the solution.

   Thank you for taking the time to read this document. If helpful, I am available to discuss this further or any related matters.

   Sincerely,

   Stephen Pepper, P.Eng, MBA, GP LL.M, CD, rmc
   Chief Financial Officer
   S2e Technologies Inc.