PO-CH/N4/0876
PART A

Alex Lawson

PART A

CONFIDENTIAL
(Circulate under cover and notify REGISTRY of movement)

PO -CH /NL/ 0876

PART A

CHANCELLOR'S 1986 PAPERS ON THE EXPORT CREDIT GUARANTEE DEPARTMENT (ECGD)

(ECGD)

Begins: 29/8/86
Ends: 18/12/86

DD: 25 years
[signature] 5/9/95

PO -CH /NL/ 0876
PART A

365/15

CONFIDENTIAL

1. MR LAVELLE RV 29/9

2. CHIEF SECRETARY

FROM : H J BUSH

29 August 1986

cc Chancellor
Economic Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Anson
Mr Cassell o/r
Mr Evans
Mr Monck
Mr Mountfield o/r
Mr Peretz
Mr Turnbull
Mr Kelly o/r
Mr Gray
Mrs R Butler
Mr Mowl
Mr Stock
Mr Walsh
Mr Board
Mr Richardson

C/ Seems very unsatisfactory that this only came to light at such a late stage. CST bilateral? CR 1/9

CLASSIFICATION OF ECGD CAPITAL MARKET OPERATIONS

Summary

The CSO have advised that the degree of public sector control inherent in the financing vehicles which ECGD has been developing to enable access to capital market funding means that they will have to be classified to the public sector. This means that their borrowing would count as part of the PSBR and their associated lending as public expenditure. The consequences for export credit policy, public expenditure and the current margin negotiations with the banks are discussed below.

Background

2. In December 1983, Ministers agreed in principle to ECGD guaranteeing bond issues in unsubsidised "pure cover" cases. In June 1985, this agreement was extended to subsidised Fixed Rate Export Finance (FREF) deals. The aim was to reduce the funding costs (relative to normal bank finance) to the advantage of exporters' competitiveness in the first case and to the Exchequer in the latter. The capital market technique has also been considered (and in one instance used) to refinance country debt where the issue of a new guarantee is justified by the economic circumstances of the country concerned (the "propriety" constraint). This was on the understanding that it did not score in the PSBR.

3. We have also seen a switch to capital market financed export credits as likely to have monetary benefits, in part presentational and in part real. It has always been somewhat

perverse from a monetary policy point of view to provide support to export credits that take the form of bank lending, but not to those financed by capital market issues. For at least to the extent that capital market issues are not themselves financed by banks, then a switch to that form of financing should help to reduce the growth of bank lending, the growth of broad money, and the pressure on short-term interest rates.

4. Work has proceeded on two fronts: developing ideas about a new FREF structure which would give greater prominence to capital market finance and, at the same time, long and complex discussions with the banks and lawyers on how best to access the capital markets in practice. The mechanism devised involves the creation of special financing vehicles which would have a 100 per cent ECGD guarantee to the providers of their funding. This meets three objectives:

i. to remove business from the banks' balance sheets (so reducing financing costs);

ii. to provide the protection to holders of the vehicle's paper which would justify recommending to Ministers Banking Act exemption; and

iii. to secure terms in the market consonant with HMG's name.

The classification issue

5. The details of this alternative funding mechanism have become clearand have been put to the CSO who intend to classify the vehicles to the public sector under their normal criteria. Although the vehicles would be privately owned, the 100 per cent ECGD guarantee and the conditions and controls attaching to that guarantee, represent a sufficient degree of ECGD control for the vehicles to be defined to the public sector. The financing vehicles effectively become ECGD's creatures, though the underlying export transaction is firmly in the private sector.

6. The control ECGD would exercise over a vehicle is a development of that which it anyway exercises on the individual bank loans it usually guarantees. But such loans only represent a portion

of the banks' balance sheets. So the control issue is to some extent submerged. But this is not so in the case of the proposed vehicles with a 100 per cent ECGD guarantee. ECGD's instrumental role in setting up the vehicles strengthens even further the CSO case for public sector classification. But the argument would still apply where the initiative came from the private sector and the advantage went entirely to the banks and exporters (as in a putatative "pure cover" case). It is the control inherent in the use of an undiluted guarantee that is the problem.

7. Defining such vehicles to the public sector means that their total borrowing would be classified to the PSBR. Their lending would be part of general government expenditure (thus increasing the GGE/GDP ratio quoted in the Public Expenditure White Paper and elsewhere) and, under normal Treasury convention, part of public expenditure. The subsidy savings to the Exchequer would therefore be far outweighed by the effect of including the vehicles in the public sector.

8. ECGD will be discussing the problems with the CSO but it looks unlikely that ECGD will be able to construct vehicles which meet CSO's criteria without cutting across the other constraints (eg the need to safeguard HMG's name in the capital markets, eligibility for a possible exemption from the Banking Act) the 100 per cent guarantee vehicle was designed to meet. There may be other ways of accessing the capital markets, but the almost certain need to retain the business on the banks' balance sheets to satisfy CSO criteria will cause practical problems. Even if these can be overcome, costs will be higher and the advantage to the Exchequer of this route correspondingly reduced.

9. Apart from the loss of some possible potential reduction in monetary growth and short-term interest rates, the problems resulting from the CSO's judgment fall into two categories. Those (in the slightly longer term) for export credit policy generally and more immediate problems on live cases and in the bank margin discussions.

Export credit policy implications

10. If we prove unable to access capital markets at all, or in manifestly inadequate or inefficient ways, we will be open to criticism on a number of counts. The banks and exporting community will be puzzled about the line drawn between a guaranteed vehicle which is in the public sector and a normal ECGD-guaranteed bank loan in the private sector. The position would be that a government guarantee was used to make available funds for exporters more easily than would otherwise be the case but was not being deployed to the fullest advantage. The latter point will be of particular embarrassment inasmuch as the City have been urged to use their ingenuity to secure economies by devising means to access the capital markets for us.

11. More generally, these linked criticisms would appear to strengthen the argument for an explicitly state-backed export bank within public expenditure and PSBR which would deliver funding at HMG interest rates without going through vehicle-type complexities. Although this would expand the area of public sector activity, if accompanied by reclassification of existing FREF loans it might on certain assumptions have a positive effect on the path and level of public expenditure. However , consideration of such a radical response is outside the compass of this submission.

Immediate policy problems

12. CSO's ruling gives rise to immediate problems in three areas:

i. Bank margin negotiations.

You recently agreed (your Private Secretary's minute of 18 August) a revised negotiating mandate which included, in addition to reduced margins, proposals to refinance a proportion of FREF loans on the capital market. It was conservatively estimated that this would have yielded savings of up to £1½ million per annum in the PES period, building up eventually to £20-30 million per annum by 1994. The basis on which these proposals were constructed has been undermined by the CSO ruling. We shall be considering with ECGD and the Bank whether there are any other - inevitably

second-best - avenues to be explored with the banks. Meanwhile, despatch of the Government's proposals and a negotiating meeting on 5 September have been deferred. We will consult you on any alternative proposals that result. But, in the last resort, we may have to rest on the margin proposals themselves (where nothing has been conceded to buy bank co-operation on capital markets) and a commitment to study capital market possibilities. This will not inconvenience the banks in a material way, but adds to the difficulties of explaining already unpopular proposals.

ii. The Philippines and Yugoslavia refinancing

A mandate for capital market refinancing of approximately £100 million of Philippines/Yugoslavian debt has been awarded to Lloyds Merchant Bank. It is in this context that the vehicle structure has been most clearly defined. This is now so far advanced that stopping it is likely to be impossible.

iii. Guangdong power station sale to China

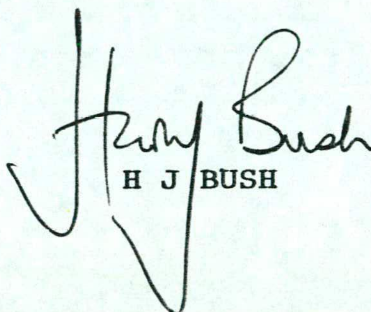
The capital market financing of this £450 million deal was prompted by the need to secure subsidy savings to finance additional concessions for the Chinese to win the business. So the savings from alternative financing (in NPV terms £13 million) have largely been spent. That would have to be borne if we did not proceed with the vehicle. However, whilst in theory it might be possible to substitute an ordinary FREF loan, in practice this will be difficult to sell to the banks, who went down this road reluctantly and at Government instigation.

13. If the arrangements for the Philippines and Yugoslavia refinancing and for Guangdong are too advanced to stop (and it seems clear that the CSO will not waive their ruling in these two specific cases), the Philippines and Yugoslav arrangements will add £100 million to public expenditure and the PSBR this year; and Guangdong will add £450 million to public expenditure and the PSBR spread over the next 5-7 years depending on draw-down schedules.

14. CSO are considering the classification of the existing CFX vehicle which funded a loan to Brazil. That would, however, be classified to 1984-85 public sector accounts and would produce a £25 million per annum inflow from January 1989 for four years as repayments come in.

Conclusion

15. We are examining urgently with ECGD, the Bank and CSO what can be done to live with the consequences of the ruling. So far as we can see at present, however, alternative means of recourse to the capital markets to finance this lending on ECGD guarantee will be less satisfactory and may not be worth pursuing. But it looks very difficult to detach ourselves from the use of such vehicles in the two cases currently under negotiation.



H J BUSH

FROM: MRS A F CASE
DATE: 30 October 1986

CHIEF SECRETARY

cc Chancellor
Economic Secretary
Financial Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Mountfield
Mr Peretz
Mr Turnbull
Mrs R Butler
Mr Kelly
Mr Bush o/r

C/ V bad that this is still unresolved.

CR 30/10

ECGD GUARANTEED VEHICLES

My minute of 17 September informed you that we had agreed to authorise the incorporation of GEFCO (the vehicle company put together by Lloyds Merchant Bank for the Philippines/Yugoslavia debt restructuring) in advance of resolution with the CSO of the question whether such vehicles should be classified to the private or public sector. If GEFCO were classified to the public sector there would be an additional public expenditure/PSBR cost of £100 million this year. GEFCO will begin to provide funds to the debtors next week.

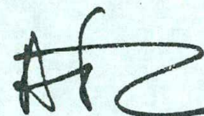
2. LMB are, however anxious, to go ahead with the bond issue which will provide the cheaper funding. The bond issue will inevitably be a public event and, at our request, ECGD have held LMB/GEFCO back in the hope that the CSO issue could be quickly and satisfactorily resolved. Despite considerable work, we are not yet at that point and ECGD feel that if they are to continue to stall they must have authority to tell LMB in confidence but formally what the problem is.

3. We have discussed this with Sir Peter Middleton and believe that we should tell ECGD to give LMB/GEFCO the go ahead for the bond issue without opening up the classification issue. They will need to consult us about terms and timing before fixing a precise date and we will then be able to think about presentation in the light of further developments with

the CSO. GE (Mr Turnbull) advises that this course will not have unacceptable consequences for the PES numbers/ratios. We would also have to authorise ECGD to take forward their negotiations with the banks involved in the Guangdong arrangements, which have been similarly stalled, on the basis that these would ultimately go forward as planned.

4. In the meantime, Sir Peter Middleton intends to go back to the CSO and persuade them that for wider policy reasons they should accept, as they have not been prepared to do so far, that these new structures be classified to the private sector.

5. Would you be content for us to proceed on these lines.



MRS A F CASE

From: SIR PETER MIDDLETON

Date: 3 November 1986

CHANCELLOR

cc Chief Secretary
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Lavelle
Mrs Lomax
Mr Scholar
Mr Mountfield
Mr Peretz
Mr Turnbull
Mrs R Butler
Mrs Case
Mr M Hall
Mr Culpin
Mr Board
Mr M Richardson
Mr Bush
Mr Stock

ECGD

You asked for an urgent progress report on ECGD classification. The answer is that we have reached stalemate as you can see from Mrs Case's minute of 31 October which I attach. All the arguments are in my letter of 8 September, Hibbert's reply of 14 October and Mansell's minute of 30 October.

2. I do not think that we can accept CSO's interpretation of the criteria as they lead to a nonsensical result. I therefore propose to send a very forthright reply on the lines attached.

3. I should add that I think that the original decision to classify FREF as private sector and use it as a wheeze to get round borrowing constraints was a bad one. But it was done with the CSO's full approval. It is when compared with existing treatment rather than with the position before the fall that the CSO's line looks so absurd.

P E MIDDLETON

DRAFT LETTER FROM: Sir Peter Middleton

TO: J Hibbert Esq
Central Statistical Office
Great George Street
LONDON
SW1

Since your letter to me of 14 October, our officials and those of ECGD and the Bank have had further discussions. Unfortunately, they have not been fruitful. And it is clear that the distinction which you suggested between asset and liability side guarantees is not workable.

2. So we are back where we were.

3. There is no argument between us about criteria. There is no argument about where we start; the existing FREF procedures are in the private sector. There is an argument about how the criteria apply to the new instruments.

4. My views have not changed. So I will not repeat them in detail. I cannot see that there is sufficient difference between the new instruments and the old to justify classing one in the private sector and one in the public. It makes no sense in terms of the management of export finance to make such a distinction. The CSO's position means that, if the private sector seeks to take advantage of capital market finance, that part of total export credit will be moved into the public sector. It does this even though the total of export credit (and debt restructuring) remains unchanged, though both capital market and bank borrowing are similarly guaranteed by ECGD, and though there is no discernible difference in the degree of public sector control.

5. To take a particular case. The export contract for the £450 million Guangdong power station has been signed with the Chinese and is being funded on the basis of traditional FREF

ie. outside the PSBR. If a vehicle is set to take advantage of better terms available in the capital markets at some time during the contract's 25 year life, you would switch the whole transaction into the public sector at that point.

6. I cannot see how your position can be justified to Ministers, to Parliament, or most important of all, to exporters. So the Treasury proposes to act on the basis that for our purposes the new vehicles will be classified in the same way as the old, ie. both guaranteed bank and guaranteed capital market finance will be classified in the private sector. And the private sector will be free to tap whichever source is cheaper.

7. I realise that you might wish to take this further. If so, I suggest you raise the issue with the Chancellor of the Exchequer.

[PEM]

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 25 November 1986

1. SIR PETER MIDDLETON
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Lavelle
Mrs Lomax
Mr Odling-Smee
Mr Judd
Mr Mountfield
Mr Peretz
Mr Turnbull
Mrs Butler
Mr Culpin
Mr Bush
Mr Stock

alternative for vehicles?

ECGD GUARANTEED VEHICLES

Since our report to you on 3 November on the stalement reached with the CSO on the ECGD classification issue, Mr Hibbert has responded to Sir Peter's letter of 4 November with a counter proposal of his own. We therefore have a choice between

(i) the "Treasury" proposal to classify the new vehicles to the private sector in the same way as the existing arrangements ie both guaranteed bank and guaranteed capital market finance will be classified in the private sector and hence outside the PSBR or public expenditure totals; and

!! (ii) the "CSO" proposal which is to classify the new vehicles to the public sector, in accordance with their standard criteria and treat them as public corporations exceptionally defining their borrowing and lending transactions as financing the PSBR rather than affecting its size (in order to leave public expenditure and the PSBR unaffected).

Neither course is fully satisfactory and officials remain divided about the best way forward.

The CSO proposal

2. The proposal is workable from a statistical and ECGD operational point of view. The problems are those of presentation and consistency with broader Government policy.

3. In terms of statistical presentation GEP would place the ECGD vehicles among the list I public corporations in the PEWP, whilst calculating their external finance in a non-standard way ie only ECGD's interest subsidies to the vehicles and not their borrowing and lending would score as public expenditure. This non-standard treatment would reflect the CSO's proposal that the vehicles' lending should be placed "below the PSBR line". The justification for this would be that the vehicles are simply facilitating private sector activity by making funds available in a suitable form. The lending itself is not a direct expression of government policy. Annexes A and B spell out the public expenditure and PSBR treatment in more detail.

4. From ECGD's point of view the vehicles would be able to raise funds in the capital markets, as originally anticipated, on terms reflecting the deployment of ECGD's guarantee and with the necessary flexibility. This would reduce the public expenditure cost compared with the existing arrangements. The CSO proposal would also have the same effect on the recorded monetary statistics as our original proposal. (That is, it would result in a lower level of £M3 than FREF lending. This could well be largely a cosmetic difference. The overall impact on underlying monetary conditions would probably be much the same in each case.)

5. In ECGD's view - they have not consulted the banks involved - classification of the vehicles as public corporations and their treatment in Government publications as ECGD "sponsored" should not make their marketing more difficult, although it clearly presents them as closer to HMG than had been intended.

The Problems

6. The novelty of the CSO proposal will inevitably attract attention, whether from the PAC or from the TCSC or TISC.

The PAC have already voiced suspicions that we are fiddling the books in allowing bank refinance by ECGD of Paris Club debt rather than bearing the cost of rescheduling immediately on the PSBR. The fact that these refinancing transactions and FREF would take place through unusual public corporations - owned by the private sector and subject to special rules in relation to their borrowing and lending - would inevitably increase suspicion.

7. The questions fall into three areas:

(i) why HMG chooses to operate indirectly through vehicles rather than to provide funding directly;

(ii) why, if the vehicles are in the public sector, do they not have access to funds raised on the finest terms by HMG;

(iii) the consistency of the new arrangements with the general rules for private finance.

8. The first question would be directed initially at Mr Gill as Accounting Officer for ECGD's public expenditure programmes (FREF) and trading account (debt restructuring). However, ECGD have made it clear that his reply would be that operating in this way provided the cheapest funds available within constraints set by the Treasury, who were unwilling to meet the total export finance bill from public expenditure. The other questions would be clearly for the Treasury.

(i) Vehicles rather than direct funding

9. Except in the limited case of debt restructuring where ECGD may be able to exploit innovative financing techniques for relatively small sums on an opportunistic basis, we could not argue that funding through vehicles was cheaper than HMG direct funding. We would need to argue in favour of vehicle finance that the Government was unwilling to see an unambiguous extension of public sector which direct funding would entail since this could damage the ability of UK exporters and their

bankers to provide competitive finance packages. This would reflect

(a) the risk that provision of finance directly by ECGD would draw it into elements of bid/negotiating process now in private sector; and

(b) the possible loss of access by exporters to innovative deals or to front-end finance and other services, that could result from the replacement of private sector banking expertise by a public sector service.

(ii) Access to public sector funds

10. On questions about why export lending though public sector vehicles was being denied the benefits of cheaper public sector funds, to the benefit of the taxpayer or the exporter, the answer to the PAC would need to be

(a) the new arrangements will be hybrid. The present bank funded FREF and refinancing deals are in the private sector. New FREF will continue to be bank funded at the start of each loan transaction. Capital market funding is only an option. The tail would be wagging the dog if the national accounts classification of vehicles were to lead to a dismantling of the existing efficient export finance arrangements and its replacement by a public sector service;

(b) the Government considers that the additional costs to the taxpayer of not bringing the export finance arrangements fully into the public sector are worthwhile in terms of the benefits to exporters of securing the support and expertise of the banks ie the argument at 9(b) above.

11. Both arguments rest on the questionable assumption that the public sector would take over all export lending supported by ECGD's guarantee. In practice public sector

funding could substitute solely for the capital market funding which the vehicles would provide. This would retain the front end finance and other services now provided by the banks whilst obtaining the cost advantage of HMG's credit standing over most of the loan's life. The vehicle structure was an attempt to do this without drawing the funding into the public sector. In reply we would need to argue that providing refinance in this way would reverse the Government's decision in March 1980 to secure public expenditure savings by withdrawing the scheme under which ECGD refinanced sterling export credit lending.

12. It is unlikely that exporters will argue that the vehicles should benefit from lower Government borrowing costs. The financial benefit of such funding would not directly accrue to the exporter because the Consensus lays down minimum lending rates for officially supported finance. Indeed, treating the vehicles as public corporations will make it more difficult to argue internationally that the vehicles should be able to offer "pure cover" export finance at sub-Consensus rates, which would benefit UK exporters competitive position.

(iii) Private finance

13. Finally, there is the question of consistency with the Treasury's position on private finance. We have argued that private funding of public sector activity must either count towards the PSBR or there must be an offsetting reduction in the PSBR, achieved by reducing the public expenditure planning total. The ECGD vehicles can, with some justification, be seen as a contrary precedent, and their treatment may generate calls for other "private finance" proposals to be defined out of the PSBR. The counter arguments we would need to deploy would be

(a) a distinction can be drawn between proposals which are designed to take existing public sector activities outside the PSBR and the proposed arrangements which are intended to retain the existing position of export finance <u>outside</u> the PSBR;

(b) with no change in the extent or nature of an activity already outside the PSBR it would be meaningless in terms of fiscal policy to alter the PSBR/PE measures simply because the use of a vehicle which the rules required should be classified to the public sector;

(c) in short this is a case of the Treasury's guidance on private finance being applied and private finance being used, though it is not necessarily the cheaper source, in the interests of providing the best service overall.

Treasury proposal

14. Some of these questions would arise even with the Treasury proposal, although it would be less likely to attract attention since there would be no special treatment within the public sector to be explained in the PEWP or national accounts handbook. However public sector classification will be unexpected and the delay in the negotiations with the banks, if nothing else, will have to be explained to the PAC.

15. On classification, we would explain that the new arrangements were an extension of the existing ones, and that the essential similarity of the underlying transactions justified the classification of the vehicles to the private sector along with the rest of export credit finance. We would not seek to challenge CSO's normal rules but point out that to apply them mechanically would draw a distinction between two bits of export finance which made little sense in terms of policy management. Nevertheless, damage could be done by the Treasury's willingness to overturn the CSO's criteria which we have previously defended.

16. The PAC might also question whether the new arrangements were the most cost-effective. We would answer that they were, looking at export credit financing transactions as a whole and taking account of the Government's preference for private sector activity and the risk that the provision of finance

by the public sector would limit UK exporters' access to front end finance and other services.

Conclusion

17. The CSO proposal is technically workable in terms of statistical presentation and of ECGD's proposed operation in the capital markets. It would secure the public expenditure savings and monetary benefits. However, it does so only on the basis of special treatment which will inevitably attract attention and could be criticised by the PAC.

18. Paragraphs 9-13 above suggest how the special arrangements could be justified but, in OF's view, the best outcome would be if CSO could be persuaded that, while we were not challenging the validity of their normal guidelines on classification, their strict interpretation would, in this instance, produce an outcome which was unsatisfactory when looked at in the wider policy context. Their proposal would make a distinction between different transactions which, from the point of view of export finance have no significance; and it would call into question the long-standing policy of a largely private sector managed and funded export finance system, thereby making it more difficult to carry through desirable policy changes. At the same time, their proposal would not add materially to the way public sector statistics can be used to interpret developments in the economy as a whole.

19. So far, CSO have stuck to their view that the characteristics of the vehicles are such that they should be regarded as part of the public sector and that in consequence the transactions through them should be regarded as part of the public finances, although treated in such a way to leave public expenditure and the PSBR unaffected. At official level we have so far not been able to persuade CSO to adopt our preferred route. It is possible that they might be persuaded by Ministers to accept it on wider policy grounds. In the last resort, they could only be overruled by an instruction from the Prime Minister. But this course has its own costs. The independence of the CSO is a benefit to the Government

as a whole and, in GEP's view, it would be better to accept their proposal than to have a formal instruction issued.

20. You will want to consider whether to see Mr Hibbert to explain to him your wider policy concerns and to see if in the light of those he is prepared to agree to the Treasury's proposal.

MRS A F CASE

CONFIDENTIAL

ANNEX A

The normal procedure with new public corporations is to give them List I (external finance) treatment. In the case of the ECGD vehicles this would mean including in external finances their borrowing and lending, plus the interest make up subsidies from ECGD. Such a treatment would be inconsistent with the proposals to omit the vehicles from the PSBR and the level of public expenditure would be affected if the borrowing and the lending of the vehicles did not net out in a particular year. There are two other options, either to treat the vehicles as non-standard List I corporations or to add them to the planned "other" category. The only long term candidates, on present intentions, for the "other" category are the BBC, IBA and the Bank of England.

2. To treat the vehicles as non-standard List I corporations we would, in conformity with the PSBR proposal, define their borrowing and lending out of external finance. The interest make up subsidies from ECGD plus initial equity injections by ECGD would remain, thus achieving almost the same public expenditure effect as the existing FREF scheme and also avoiding a series of defined zeros in the public expenditure White Paper against the vehicles. There are precedents for non-standard List I treatment. Two nationalised industries, the National Girobank and the Post Office, exclude from their external finance calculations those financial transactions which they carry out as part of the normal business activities. However, treating the vehicles as non-standard List I corporations would not obviate the need to justify their unusual treatment.

3. The alternative is to put the vehicles into the "other" category, but this is intended to be a very small, specialist category to house organisations such as the Bank of England and the BBC who have a special real world status rather than a special accounting treatment. Placing the vehicles in the

"other" category could unnecessarily draw attention to their unusual ownership structure and accounting treatment.

4. GEP would therefore prefer to see the vehicles as List I public corporations with a non-standard calculation of their external finance. Following the precedent of, for example, local authority bus companies, we would expect to group all ECGD vehicles together in public expenditure so that only their aggregate external finance would appear in the appropriate tables and we would not list them individually in the explanatory section. As public corporations the vehicles would appear in DTI/ECGD's chapter of the White Paper as well as in the public corporations chapter. The interest make up, under the usual table formats, would show against the vehicles in these two chapters but for some other analyses the subsidies would score against ECGD. There would, however, be no double counting.

ANNEX B

The normal PSBR treatment of the vehicles would be to place the borrowing by the vehicles "below the PSBR line" financing the lending grouped with expenditure "above the line". The lending would therefore affect the size of the PSBR. Under the CSO proposal the lending would be placed below the line so that borrowing and lending by the vehicles would all finance the PSBR, rather than affect its size. The rationale for the usual practice of placing the financial transactions like lending above the PSBR line is that they are expressions of government policy, akin to direct expenditure. The justification for not doing so with vehicle lending rests on the argument that the vehicles are simply facilitating private sector activity by making funds available in a suitable form. The lending is not of itself a direct expression of government policy. The treatment of the Exchange Equalisation Account, whose purchases of foreign currency are below the PSBR line, can be seen as supporting the treatment of the vehicles, although the analogy is not exact.

2. The CSO proposal is to place the borrowing of the vehicles in line 20 of the attached table. It fits naturally although the numbers would be larger than the present entries. The lending will most probably be placed in line 14, with a new sub-line, 14.3, and a suitable description which will need to be explicit, given the unusual nature of the line.

3. The borrowing and lending will therefore be clearly visible. They will also feature in several other tables in "Financial Statistics".

From: 'Financial Statistics', HMSO October 1986

1.1 Financial account: analysis by sector and type of asset

Second quarter 1986

£ million

	Line number	Public sector: Central government	Public sector: Local authorities	Public sector: Public corporations	Financial companies and institutions: Monetary sector	Financial companies and institutions: Other financial institutions	Industrial and commercial companies	Persons	Overseas
CAPITAL ACCOUNT									
Saving	1	-2,541	1,065	1,255		1,864	6,549	8,489	210
Capital transfers (net receipts)	2	-131	-6	93		-69	120	-7	-
Gross domestic fixed capital formation	3	661	634	1,193		1,466	5,948	4,642	-
Increase in value of stocks and work in progress	4	-38	-	-33		-	393	121	-
Financial surplus or deficit	5	-3,295	425	188		329	328	3,719	210
FINANCIAL ACCOUNT									
Notes and coin	6	491		-	-93	-	-146	-340	88
Market Treasury bills	7	-191	-2	26	227	12	-73		1
British government securities	8	-2,237	-12	55	588	250	-100	789	667
National savings	9	-618	-	-42	-	3	22	635	
Tax instruments	10	-582	-	64	8	329	182	-1	
Net government indebtedness to Banking Department	11	-1,048			1,048				
Northern Ireland central government debt	12	-5			-3	-	-	8	
Government liabilities under exchange cover scheme	13	70	-1	-62			-7		
Other public sector financing:	14								
Non-marketable debt	14.1	239	-	-132	-107	-			
Short-term assets	14.2	-	385	-2		-265	-83	-27	-8
Issue Department transactions in bills, etc	15	-3,148					1,453		1,695
Government foreign currency debt	16	31			-32	-9			10
Other government overseas financing	17	-							-
Official reserves	18	296							-296
Local authority debt:	19								
Temporary	19.1	29	990	-133	-441	-146	-53	-245	-1
Foreign currency	19.2		-45		-	-			45
Sterling securities	19.3	249	39	-	-89	13			
	19.3+.4						-1	-735	-1
Other sterling debt	19.4	3,417	-2,502	-6	-316	-68			
Public corporations debt:	20								
Foreign currency	20.1			172	-37	-			-135
Sterling	20.2	-25	50	253	-260	13	-	-19	-12
Deposits with banks:	21								
Sterling sight	21.1	-56	57	-43	-3,898	577	767	3,041	-445
Sterling time	21.2	36	1,141	498	-4,029	-85	1,561	1,295	-417
Foreign currency	21.3	-2	3	6	-10,446	1,196	993	-166	8,416
Deposits with building societies	22		-		68	-3,118	89	2,880	81
Deposits with other financial institutions	23	-				-	-	-	-
Bank lending (excluding public sector):(1)	24								
Foreign currency	24.1				7,260	-3,221	1,936	-304	-5,671
Sterling	24.2				7,482	-1,435	-1,280	-2,552	-2,215
Credit extended by retailers	25			-2			-105	107	
Identified trade credit:	26								
Domestic	26.1	-212		-770		-5	586	401	
Import and export	26.2	-		25		-	57		-82
Loans for house purchase:	27								
Building societies	27.1					4,936	-16	-4,920	
Other	27.2	-	-102	-36	1,147	330		-1,339	
Other public sector lending	28	46	11	8	-	-	3	1	-69
Other lending by financial institutions	29			-		-111	-22	133	-
Unit trust units	30					-759		759	
UK company securities	31	-1,091		-1	386	1,494	-1,749	-208	1,169
Overseas securities(1)	32	-			2,304	4,310	728	73	-7,415
Life assurance and pension funds	33	-257				-4,764		5,021	
Miscellaneous domestic instruments	34	-20	-6	6	-	-295	-109	424	-
Direct and other investment abroad	35			-	90	17	462		-571
Overseas direct and other investment in UK	36			-	-78	173	-818	-40	763
Miscellaneous overseas instruments	37	-39		6	-	-330	..		..
Accruals adjustment	38	453	-825	210	7	-324	442	37	
Total financial transactions	39	-4,174	-819	100	786	-1,282	..	4,710	..
BALANCING ITEM	40	879	1,244	88		284	..	-991	..

These items finance the PSBR ↑

These items affect the size of the PSBR ↓

Sources: Bank of England
Central Statistical Office

Relationship between lines: 1+2-3-4=5; 6 to 38=39; 39+40=5.

Acquisition of assets or reduction in liabilities is shown positive: sale of assets or increase in liabilities negative.

1. See supplementary information notes on bank borrowing and transactions in securities

CONFIDENTIAL

C/ Unfortunately, it proved absolutely impossible to hold a meeting at a time when the CST cd. come
CR 11/12

FROM: SIR PETER MIDDLETON
DATE: 28 November 1986

CHANCELLOR

C/ Shall we arrange meeting?
CR 28/11

Yes pse. Invite Mr Wilson, Peter also. (also Mr R-W)

cc Chief Secretary
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Lavelle
Mrs Lomax
Mr Odling-Smee
Mr Judd
Mr Mountfield
Mr Peretz
Mr Turnbull
Mrs Butler
Mrs Case
Mr Culpin
Mr Bush
Mr Stock

ECGD GUARANTEED VEHICLES

This has now reached the stage where we need an internal meeting with you and the Chief Secretary. Mrs Case's minute sets out the state of play.

2. The CSO have come up with an offer. We are not agreed on whether to accept it. AEF think no, GE think yes. Mr Butler is inclined to go with GE, I am inclined to come down on the AEF side.

3. Much depends on one's starting point. Looked at from the point of view of first principle, there is much to be said for the CSO's position. Looked at from the point of view of precedent (ie the existing classification of export credit) there is very little to be said for it.

4. I have three concerns about the suggested compromise. First, bits of export credit flit in and out of the public sector according to the shape of the yield curve - and whether capital market or bank finance is cheapest. Managerially this is pretty silly, and it will take a lot of explaining to the exporting community.

5. Second, if the new arrangements are in the public sector, what started as a proposal for relatively cheap finance looks like an offer of expensive finance. Why go to all the trouble of setting

up these complicated vehicles when we could simply lend on NLF terms as we do elsewhere in the public sector. It is clear from the ECGD that they would expect the Treasury to answer this. I do not very much relish this prospect.

6. Third, it messes up what looked like a neat new classification of public corporations - whether the ECGD vehicles are in List I or in the "other" category.

7. However, as the CSO may want to go to the Prime Minister we had better be clear about our own position before we taken things further with them.

pp P E MIDDLETON

CONFIDENTIAL

FROM: MRS A F CASE
DATE: 18 December 1986

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Lavelle
Mr Wilson
Mrs Lomax
Mr Odling Smee
Mr Judd
Mr Mountfield o/r
Mr Peretz
Mr Turnbull
Mrs Butler
Mr Culpin
Mr Bush
Mr Stock
Mr Ross-Goobey
Mr Tyrie

C/ Shall we fix meeting with Mr Hibbert in new year. Just you and him?

Ch
Speaking notes much too long – but can edit them down before meeting
AA

ECGD GUARANTEED VEHICLES

I attach a speaking note for you to use with Mr Hibbert of the CSO on this subject. It rehearses the difficulties which we see in the CSO's proposal and appeals to Mr Hibberd to adopt the "Treasury" proposal ie private sector classification as a pragmatic response to the policy problem.

2. Paragraph 3 of the speaking note briefly touches on the alternatives mentioned at your meeting. We have not had time to examine these in great depth but, as I indicated then, they seem unlikely to offer an easy way out.

3. The negotiations with the banks on other aspects of the FREF scheme, in particular the margin, are not going well. There is little or no good will to trade on. The banks are unlikely to be receptive either to the idea of a return to the status quo ante (unless that meant continuing with the present arrangements where they can cream off some of the savings we are seeking to secure for the taxpayer) or to taking

the securitised lending on their own balance sheets. This last course was raised earlier in our negotiations but dropped since neither the banks nor we found it attractive. If they could be persuaded to keep this lending on their balance sheets, they would seek additional compensation through the margin. They would also want to use vehicles to access the capital markets, thus linking the funding to the underlying guaranteed assets and avoiding using up their own credit in the market. We have established with the CSO that bank owned vehicles consolidated on their balance sheets would in their view form part of the public sector, if there continued to be a liability side ECGD guarantee. Because of the implications for the Exchequer, we do not think we can forego these conditions. Without a liability guarantee, the savings to be secured by switching to the capital market would be very limited: the instrument would either be much less flexible, operating only on a fully matched basis, or it would need a (costly) capital base. The only example of this sort of approach is the CFX vehicle, part owned by Morgan Grenfell. This refinanced Brazilian Paris Club debt through FRNs at a rate of 1/8th over LIBOR ie more than the reference rate for existing bank funded FREF.

4. It might also be helpful to set out the savings which we have assumed could be secured from the negotiations with the banks. The figures set out in the first two lines of the table below have already been built into the PEWP numbers.

		1987-88	1988-89	1989-90
				£million
1.	Savings on margin	1.3	3.4	6.0
	Savings on funding			
2.	new FREF	0.2	0.6	1.0
3.	old FREF	12	12	12

The savings are small. This is because the lower costs would only apply to new business and the savings therefore build up only gradually. In addition the funding savings in lines 2 and 3 are based on very conservative assumptions about the extent to which refinancing through the capital markets would take place. Line 2 assumes only 10% of new FREF would be funded in this way. Once ECGD had some experience, we would hope to increase that proportion considerably. Bigger and more immediate savings could be made from substituting capital market funding in the financing of FREF already on the books (line 3). We have no means of imposing this substitution and it may only prove possible to buy the banks' co-operation by forgoing some of the margin savings.

5. ECGD also want to use the capital markets to fund Paris Club restructurings. The comparisons here are more difficult. The capital markets would be considerably cheaper than bank refinance with benefits to ECGD but the comparison with finance from the Consolidated Fund for the alternative rescheduling (on PSBR) route is less clear cut. ECGD, however, believe that they can better the cost to them of their notional borrowing from the Consolidated Fund through innovative and opportunistic access to the markets for relatively small amounts.

6. Finally, although there is no deadline for resolving these problems, it is a case of the sooner the better. The negotiations with the banks have been stalled since August, with some damage to our negotiating position and credibility. In addition negotiations with a number of debtor countries over their Paris Club restructurings are reaching the point at which ECGD need to decide whether to assume a capital market operation.

MRS A F CASE

EXPORT FINANCE : CLASSIFICATION

Speaking Note

Have thought carefully about problems over classification of export credit financing.

- Share concern not put in jeopardy rules which have been carefully devised. Grateful for work done by CSO.

- Recognise CSO has gone long way, shown considerable ingenuity in trying to meet our requirements and retain integrity of rules.

2. Your proposal (taking transaction outside PSBR and public expenditure) helpful in operational terms but remain very anxious about wider policy consequences for HMG if adopted.

3. Have looked to see if any alternative way through classification issues raised by vehicles. Not easy. Negotiations with banks already difficult for other reasons. Banks would want vehicles for market reasons, even if, like current FREF, funding remained on their balance sheet. Other approaches would considerably reduce prospective savings

[- Can't go back to scratch. Problem remains.]

4. Case for tapping capital markets and obtaining benefit of securitisation in lower funding costs for taxpayer - simple and self-evident. Proposals developed to achieve simple objective tortuous and raise unhelpful policy questions.

5. Four points of concern.

6. First, present export finance system traditionally private sector affair, though facilitated by ECGD.

- No change proposed in basic rationale, nevertheless your proposal splits flow of export finance in accounting terms between public and private sectors. Export finance would switch from one to another in response to relative interest rates. Transactions would start off in private sector with funds drawn from interbank market, switch to public sector

when funds from capital market substituted. Odd to reclassify possibly more than once during life of a credit from one sector to another.

- Accounting treatment will obscure rather than clarify size of transactions and extent of HMG assistance.

7. Second - more substantive problem - if transactions fall within public sector, scheme designed to reduce cost to taxpayer of existing arrangement ends by looking as if it adds to costs. Financial benefits same but will look unappealing by comparison with NLF rather than bank finance.

8. Presentation awkward too. No wish to change present private sector basis of system. Obviously need to ensure HMG's subsidies (difference between Consensus and market rates) are minimised. If in minimising, part of finance is brought within public sector, this will increase pressure for purely public sector operation.

9. Third - other countries, including French, beginning to copy our bond guarantee ideas - also on cost reduction grounds to encourage "pure cover" (no subsidy) operations in rich markets. Classification of vehicles to public sector involves real risk that UK exporters may be denied these advantages. Our competitors will claim that as public corporations rather than private companies vehicles must be official institutions bound by Consensus rules. Other countries classify their export credit institutions differently (Coface and Hermes - French and German agencies - both private sector companies).

10. Finally - point which most closely involves CSO's own interests - very ingenuity of solution proposed will inevitably attract attention.

- Public sector classification will be unexpected - history of private sector classification and purpose of limited change proposed known to be cost saving.

- Special treatment - vehicles in public sector but borrowing and lending excluded from public expenditure and PSBR - will

inevitably raise suspicions of HMG fiddling the books. Suspicions difficult to dispel. Just as bad for you as us.

10. Solution which seems least likely to present these problems is the one which cuts across the existing rules ie treat vehicles as in the private sector.

11. Understand way in which application of CSO's normal guidelines have led to your ruling that vehicles would be public sector. But ask you to recognise policy problems rising from straightforward application of principles.

- Conclusion - make an exception for these operations on pragmatic grounds. No difference in basic rationale only form, between new proposals and traditional bank funded FREF and refinancing.
- Prefer not to do this. But for wider reasons would provide least damaging way to achieve what all agree is in general interest.