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the department for Enterprise

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Dear Norman

IRAQ: PREMIUM REFUNDS

Issue

I am writing to propose guidelines for handling applications for refunds of ECGD premium from exporters with contracts with Iraqi buyers which have been frustrated by UN Sanctions. To date, ECGD has received about 50 applications; potentially there could be 145 contracts affected.

Background

2. These contracts were being financed under ECGD-Guaranteed Lines of Credit. The result of contract frustration has been that the full amount of finance originally approved for the contract has not been drawn by the exporter. Exporters are arguing that because they have not received the full benefit for which they have paid premium, ie the finance approved for the contract, they are entitled to a premium refund in relation to the undrawn balance. Some have pressed for refunds pro-rata to undrawn finance.

3. The sums involved are substantial - an average 11% of the Contract Value - which in turn reflects the high risks which ECGD were taking on. The total undrawn balance on all contracts is about £155m. If we refunded premium pro-rata, we would be paying out £17m.

Recycled Paper

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ECGD's Current Refund Policy

4. Once ECGD has committed itself to a risk, the exporter is not legally entitled to any refund. Refunds are, however, considered on an ex-gratia basis. The maximum refund normally permitted is 75% which is payable only if a contract is frustrated before any finance is drawn from the ECGD-Guaranteed loan. The 25% retention is to cover ECGD's commitment to take on the risk in the first place, and to cover administration costs. If the contract is frustrated after work has begun, a further element of the premium is retained to reflect the risks which have been run by ECGD in relation to completed work.

5. However, it is implicit in this policy that ECGD does not face a potential loss. In other words, refund questions have in the past tended to arise when the contract has been terminated amicably as a result of agreement between exporter and buyer. In the case of Iraq, however, ECGD will have to meet substantial claims under its guarantees to banks in respect of the finance which has already been drawn under its Iraqi credit facilities, with very poor recovery prospects. This would suggest a tighter stance on refunds. Against that, it is ECGD who is withdrawing from the arrangement with exporters which would make it very difficult to defend not making some refunds of premium in respect of finance which exporters will not be able to draw - notwithstanding ECGD's potential losses. In short, ECGD's current refund policy was not designed with Iraq in mind.

Proposals

6. I have asked ECGD to review their policy on premium refunds taking into account the Iraqi experience, and this will be pursued in due course with your officials. But we need to settle our Iraq policy now - we cannot wait for the review. My proposals are intended to strike a balance between ECGD, who face substantial potential losses on their Iraq commitments, and exporters who will also have lost money as a result of their contracts being frustrated. They also reflect our general intention not to pay compensation to exporters except through legitimate claims payments under ECGD's Guarantees. Accordingly, I would divide contracts into three categories:

(1) Those where no drawings had been made on the loan. Here, ECGD has not assumed any risk on the contract in question. I would propose that we refund 85% of the premium paid. The 15% retention is designed to cover administration costs and ECGD's commitment to risk. A lower retention percentage than under current policy (25%) is justified because ECGD's premium rate on Iraq is twice the overall average for project business.

(2) Contracts where loan drawings are less than the premium paid. On these contracts, I propose that we should refund 85% of the difference between the premium paid and the drawings made from the loan. Although, strictly speaking, ECGD would be within its rights not to make any refund because of the losses which it faces on the drawings already made, I think we need to temper this strict stance - the exporter could always offer to repay all of the loan monies which he had drawn, which would then put him broadly in the same category as the exporter who has drawn no money at all.

(3) Contracts where loan drawings exceed premium paid. On these contracts, I would propose not to pay any refunds at all. Some exporters in this category, however, may be able to obtain some compensation if they have taken out ECGD's contract frustration cover. In principle, ECGD premium in respect of both guaranteed loan finance and the contract frustration cover itself could be considered to be a cost incurred in connection with the contract and thus be eligible for a claims payment. One of the strongest reasons for not paying ex-gratia refunds for exporters in this category is that this would be to compensate exporters who have not been sufficiently prudent to take out contract frustration cover. This, in turn, would weaken our general line on compensation as I have set out above.

7. The cost of this package would be about £9.7m. If we were to refund premium at a rate of 75% rather than 85%, this would reduce by £1.1m. Further, if we were to restrict

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refunds only to contracts where no drawings had been made, this would save a further £4.6m. I would not, however, favour cutting back the package in this way because I believe it would be widely regarded as unfair, and difficult to defend on grounds of either logic or equity.

Conclusions

8. Although I believe this package to be a fair balance between the exporter and the taxpayer, I am afraid that many exporters will not see it that way, particularly if they have not taken out ECGD contract frustration insurance. A number of them are feeling very aggrieved about the losses which they face on contracts which have been frustrated by Sanctions, and you will know of the pressure upon Government to compensate companies who are suffering these problems. I do not see as a legitimate role for ECGD to try to compensate all exporters for the losses they have incurred as a result of Sanctions unless they are justified by the terms of the Guarantee and a balanced policy on ex-gratia refunds, but it makes it all the more important for our policy on refunds to be seen to be both fair and balanced to both taxpayer and exporter.

9. I would be grateful for your early agreement to my proposals. I am starting to receive quite a volume of correspondence from MPs and exporters, and I would like to settle our policy stance soon so that ECGD can start to refund money to exporters.

10. I am copying this letter to the Prime Minister, Douglas Hurd, Tom King and to Sir Robin Butler.

Yours ever
Tim

TIM SAINSBURY