File

SO

FROM: N H SCOTT-BARRETT
DATE: 5 October 1984

AF257x

1. ~~MRS CASE~~
2. ECONOMIC SECRETARY

cc PPS
Chief Secretary
Financial Secretary
Minister of State
Sir Peter Middleton
Mr Littler
Mr Unwin
Mr Mountfield
Mr Lavelle
Mr Scholar
Mr Gray
Mr Hall
Mr Kelly
Mr Hannah
Mr Illet
Mr Lord

ECGD: LIABILITY TO 'TAKE-OUT' LOANS IN US DOLLARS AND DM

will request if required

Mr Channon replied on 11 September to your letter of 4 September in which you had proposed the ending of 'take-out' for new business. He shared your concern about the growth of 'take-out' liabilities, and accepted that the facility should be withdrawn for future business. However he was concerned that, before any approach to the banks, there should be an urgent review by officials of possible effects and alternative options.

2. This review has taken place, and a report (copy attached) was attached to Mrs Case's submission of 27 September. It was sent to Mr Channon by ECGD officials at the same time, and recommends that officials should now open discussions with the banks on how to implement the withdrawal of take-out for new business with the objective of achieving this by 30 November. Officials would report back to Ministers if these discussions suggested unacceptable consequences for the availability of dollar or deutschemark finance or problems in implementing the change without an increase in public expenditure through a higher margin.

3. We understand that the Mr Channon accepts these recommendations, and the way is now clear for the discussions to begin. ECGD officials would be in the lead, but Treasury and Bank officials would take part.

4. A draft letter is attached.

N H Scott-Barrett

N H SCOTT-BARRETT

DRAFT LETTER TO MINISTER FOR TRADE

ECGD: LIABILITY TO 'TAKE-OUT' LOANS IN US DOLLARS AND DEUTSCHEMARKS

Thank you for your letter of 11 September. I am glad that you are able to accept that 'take-out' should be withdrawn for future business.

In your letter, you asked for an urgent review by officials of the possible effects of withdrawal and of alternative options. You will by now have seen the conclusions of this review, with which I agree, and the way is now open for discussions with the banks to begin.

I therefore propose that our officials be instructed to open discussions as soon as possible with the banks on how to implement the withdrawal of 'take-out' for new US dollar and deutschemark loans with effect from 1st December 1984. No alternative facility would be offered, but officials would report back to us if the discussions suggested that there would be:-

(a) unacceptable consequences for the availability of dollar or deutschemark finance; or

(b) problems in implementing the change without conceding an increase in the margin, and hence additional public expenditure.

ECGD : TAKE OUT

At the bilateral meeting between the Chief Secretary and the Secretary of State for Trade and Industry on 6 September, the Chief Secretary asked that further discussion between officials on withdrawing take out facilities from ECGD guaranteed loans in US Dollars and deutschemarks should be pursued quickly so that consequent public expenditure implications could be taken into account in the current public expenditure exercise.

2. Officials from Treasury, ECGD, DTI and the Bank have now discussed further the effects and alternative options for ending take out. Our conclusions are as follows:-

(i) it is feasible to maintain the ECGD dollar financing scheme without the take out provisions, although ECGD's documents would need to be amended to ensure that they were not liable to meet the borrower's inability to make the accelerated repayments required if the bank were unable to renew its Eurocurrency funding ie take out by another route. The US dollar and deutschemark facility would not be altered in any other respect and the change would simply put ECGD-backed Eurocurrency loans on all fours with the terms of much other Eurocurrency lending, which is often unguaranteed;

(ii) the effect of withdrawal would be to pass the credit risk in the event of the collapse of currency markets from HMG to the borrower. This increase in risk might affect the willingness

(a) of banks to provide dollar finance;
(b) of overseas borowers to contract with UK suppliers in foreign currencies and therefore the latter's competitiveness; and
(c) the security of funding which UK suppliers currently enjoy.

Officials were unable to estimate the impact of these possible consequences for UK exports and for the interest make-up account (public expenditure). The change could affect UK banks more than US banks whose access to US domestic dollar deposits is easier;

(iii) it is not easy to see alternatives to take out which would be acceptable to HMG and which would also reduce any unacceptable impact on the availability of foreign currency finance. The banks however might have ideas and these could be discussed;

(iv) take out provisions should be retained at ECGD's option to protect the Exchequer where the cost of interest make up is deemed to be excessive. Before exercising this power, ECGD would consult the Treasury to enable reserve management as well as public expenditure considerations to be taken into account;

(v) take out in its present form should be withdrawn for both US dollar and deutschemark loans, ie both currencies where it is currently available. It is unclear whether the availability of take out plays a significant role in encouraging the use of deutschemark finance and hence lower public expenditure costs. The greater the success in increasing the use of deutschemark finance, the sooner it would give rise to the same reserve management and propriety issues and hence the need to withdraw the facility;

(vi) there is a strong possibility that the banks may seek an increase in the margin (currently between 3/8% and 7/8%) on US dollar lending payable by HMG, ie in their remuneration, to compensate for the additional risk. It has been suggested that 1/8% might be sufficient. There is no way of testing this or its potential cost since the latter depends on the volume of future foreign currency business which in turn will be affected by the withdrawal of take out. On current volumes, however, each 1/8% conceded would imply a continuing £6 million per annum public expenditure cost. In discussions with the banks it should therefore be resisted although a concession might have to be considered if this seemed the only way of securing an acceptable flow of dollar or deutschemark finance.

3. In the light of these conclusions, Ministers are invited to confirm that officials should open discussions with the banks on how to implement a withdrawal of take out for new US dollar and deutschemark loans. The objective would be to withdraw take out for loans made after the 30 November 1984. No alternative facility would be offered. Officials would report back to Ministers if discussions with the banks suggested that there would be

(a) unacceptable consequences for the availability of dollar and deutschemark finance; or

(b) problems in implementing the change without conceding an increase in the margin and hence additional public expenditure.