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B/F with CST's response

1 October 1984

MR TURNBULL

ECGD: MATTHEWS REPORT

Mr Channon has written to the Chief Secretary on the inter-departmental report on the Matthews proposals.

The consensus appears to have emerged that the formation of a Corporation to take over ECGD, as suggested by Matthews, has a number of drawbacks, including the requirement for contentious primary legislation without the possibility of effective privatisation. In these circumstances, we think ECGD should be left as a separate department.

We agree that the proposed management study should proceed and that, following this, measures to improve staffing and administration of the department need to be considered.

However, the financial position and control of ECGD give grounds for concern in that:

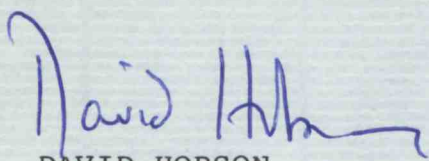
- a. ECGD has very large commitments which can have a significant effect on the PSBR if things go wrong.
- b. There is expected to be a negative cash flow in sterling over the next 3 years of the order of £300m per annum.

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- c. There is uncertainty as to the amount needed to provide for doubtful overseas debts, which is under discussion with the C&AG, who is said to be reluctant to endorse the accounts without further provision. There is some similarity to the position of commercial banks lending to the Third World.
- d. Pressure is exercised on the ECGD by its sponsoring department, and others including FCO and Defence, to accept some large risks which the department is unwilling or reluctant to take on within the existing guidelines, as constituting excessive amounts of risky business, possibly at inadequate premiums (eg Tornados for Turkey).
- e. The staffing and administration areas have given rise to problems, especially the recruiting of sufficient specialists, leading to complaints about the standard of service to industry.

We suggest that the Chancellor of the Exchequer should be asked to consider whether the suggestions put to Ministers provide for sufficiently firm financial control over the department and, if not, suggest how best to exercise and achieve this.


DAVID HOBSON

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EST
Sir P Middleton
Mr Bailey
Mr Littler
Mr Unwin
Mr Monck
Mr Kemp
Mr Montfield

Treasury Chambers, Parliament Street, SW1P 3AG

Mr Scott-Battett
Mrs Case
Mr Lord
Mr Ridley

28 September 1984

Rt Hon Paul Channon MP
Minister for Trade
Department of Trade and Industry
1-19 Victoria Street
London SW1H 0ET

John Paul

MATTHEWS REPORT ON ECGD

Thank you for your letter of 17 September setting out your first thoughts on the report by officials on the follow-up to the Matthews Report.

2 As your letter recognises, I will be very heavily engaged on the public expenditure round over the next few weeks and I note that you want to make an early announcement to Parliament. Given that you seem generally to accept the recommendations from officials, I do not want to hold up consideration of the report and Trade Ministers' views by our colleagues and would therefore be happy for the report to be circulated to EX without any preliminary consultation with me.

3 Your letter also mentions the idea of an additional Under Secretary post for the Department. I understand that there has been some discussion about this between our officials. The right course seems to be for the Secretary of ECGD to put forward the case as quickly as possible. We will of course bear in mind the point you make about our public response to the Matthews Report.

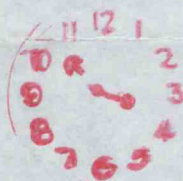
Peter Rees

PETER REES

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MANAGEMENT IN CONFIDENCE

TRADE: ECGD Jan 80

[- 8 OCT 1984]



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From the Minister for Trade

The Rt Hon Peter Rees QC MP
 Chief Secretary
 HM Treasury
 Parliament Street
 London
 SW1P 3AQ

17 September 1984

New Chief Secretary

MATTHEWS REPORT ON THE ECGD

Attached is a report by an inter-departmental group of officials which considers the implications of a recommendation by the Matthews Committee that ECGD should be turned into a Government-owned corporation. Ministers now have to decide what should be done with a view to an early announcement to Parliament. However, before Norman Tebbit writes to you and other colleagues in EX with this Department's formal views, I thought it might be worth my giving you our first thoughts.

In opting for a Corporation run on "commercial" lines, Matthews was seeking a greater clarity in objectives and accounting, including much sharper distinction between insurance which is justifiable against commercial criteria, and that provided in the national interest. He also saw the Corporation with its capital structure and commercially motivated board as a means of injecting a more business-like approach into ECGD's organisation and management.

It seems clear that Matthews' objectives are desirable and we could implement his recommendation. Against this, the change would require primary legislation, which would be opposed, and difficult financial and operational issues would have to be settled. These include capitalisation (with important implications for Public Expenditure), the functions, staffing, and the relationship with Government. Thus the process of change would be extended and painful. Moreover, there may be some danger that a Corporation with a tight commercial mandate, coupled with power to re-insure with HMG, and a free rein on staffing would provide a poorer range of cover at greater expense than ECGD.



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It may be that there is enough scope for change within the present framework. ECGD's response to the Financial Management Initiative will go a long way towards meeting Matthews points about clearer objectives and accounting. The managerial issues are perhaps less tractable, not least because Matthews himself was not very specific about them. Those commentators - and there are many - who support Matthews, are equally vague, apart from pleading in a generalised way for greater flexibility - by which they all too often mean bigger and better cover in the riskier markets, i.e. looser financial objectives. There are however many who feel that ECGD has had a raw deal in the past in a variety of staffing issues, as a result of Government intervention in numbers, grades, and location of manpower, without adequate regard to the needs of ECGD's customers.

I understand that officials in the MPO and Treasury are willing to consider any special managerial/staffing needs in ECGD provided they are adequately identified and articulated. To enable this to be done it seems to me that we need a small team of officials together with one or two outside consultants to look in more detail than Matthews was able to do at the tasks ECGD is undertaking, and the ideal arrangements for recruiting, motivating and retaining staff of the necessary quality to discharge those tasks. In short, I would go along with para 33 of the note by officials.

I am attracted by the idea of a mixed public/private sector team to look into ways of encouraging the private sector to play a greater role in export credit insurance and finance. I am afraid to say that I agree with the report that privatisation as such is clearly a non-starter at present but it should be possible to develop the banks' schemes for covering smaller exporters, and there could well be scope for collaboration between ECGD and the burgeoning private sector insurers. One way of pursuing this would be to co-opt into ECGD's management, perhaps on a part-time basis, a private sector individual with relevant experience, with a specific remit to explore the possibilities. I also believe that we should set up a joint public/private sector working party to examine the possibility of an Export Board largely owned by the private sector but which might have a minority government or Bank of England involvement.

At the same time I suspect there is a case for some permanent strengthening of ECGD's top management, perhaps by the restoration of an Under Secretary post which was lost from the establishment some 4 years ago. A great deal has happened since then particularly in the context of third world debt problems and their impact on ECGD's activities, and I am sure that it would be helpful, if in announcing whatever our decision turns out to be on Matthews', we were able to point to some strengthening at the



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top, possibly by filling the Under Secretary post from outside.

I should like to discuss your views on my proposals. I am returning from an overseas visit in early October. I understand that you hope to be free from the diary constraints imposed by the PES bilaterals by then. Perhaps we could meet during the first week of the month?

Yours sincerely
S. Nield

for PAUL CHANNON

cc PS/SoS
PS/Sir Anthony Rawlinson
Mr Gill ECGD
Mr Roberts
Mr Hutton OT2
Mr Kemp ECGD
Mr Ranson ECGD
Mr Chapman PEP3
Miss Neville-Rolfe PEP2 (or)

External
Mr Raison
Ex Members
Sir R Armstrong

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**ECGD - IMPLICATIONS OF THE REPORT OF THE
"MATTHEWS COMMITTEE"**

Note by officials

SUMMARY

1 Matthews recommended that ECGD should be turned into a State-owned corporation. The pros and cons were not argued out in detail. Officials have considered the implications and now seek a steer from Ministers.

2 Officials accept Matthews' view that there is no scope for privatisation, but that efforts should be made to encourage the private sector to play a greater part in export credit insurance.

3 The arguments for providing Government backing through a corporation or (as at present) a Government Department are not clear cut.

4 A change to a corporation would involve primary legislation, which would be opposed. There would be very difficult issues of finance, organisation, control, and relationship with Government to be resolved. The transitional costs could be severe; the benefits uncertain and longer-term.

5 The present arrangements work well on the whole. Criticisms are in many cases misguided and strike at ECGD's financial objectives as much as its operational procedures.

6 The alternative to a corporation is to identify more precisely and to try to deal with legitimate criticisms within the present framework. ECGD's response to the Financial Management Initiative will go a long way towards clarifying financial objectives and responsibilities. The remaining problems relate to managerial and staffing questions which maybe be soluble at least in part by introducing more flexibility into the present arrangements eg by the creation of a special Departmental grade of underwriters and the introduction in appropriate cases of performance-related pay. If Ministers prefer this approach rather than the creation of a corporation a detailed study of staffing and organisation led by ECGD and involving civil service and outside expertise is recommended.

7 Independently of the decision on Matthews, the case for the creation of an export bank deserves further, separate, study.

INTRODUCTION

8 In August 1983 a small committee chaired by Sir Peter Matthews (then Chairman of Vickers), assisted by Mr Leslie (Barclays Bank) and Mr Bevins (Royal Insurance), was asked to review ECGD's structure, functions and status, taking into account the corresponding facilities available to foreign competitors; the interests of the taxpayer; and the scope for devolving any functions to, or collaborating with, the private sector.

9 The committee took evidence from a wide range of interested parties and its report was delivered in March 1984 and published. Appendix A reproduces the summary and principal recommendations, the most far-reaching of which is that ECGD should be replaced by a government-owned corporation performing broadly the same functions and reinsuring some risks with HMG. In general the recommendations reflect the main weight of the views expressed in evidence.

10 Officials from the Departments chiefly concerned (ECGD, DTI, Treasury, MPO, FCO) along with the Bank of England and the policy unit in No 10 have studied the implications of the report from the points of view of financial structure, staffing and management, trade policy, and export finance. Their reports together with notes on the activities of the private sector and on credit insurers in other countries are listed at Appendix B. This paper draws on their findings and seeks ministerial guidance on Matthews' central recommendation. An early decision in principle is desirable to help dispel the uncertainty and anxiety which now overhangs ECGD's staff and activities, and to give officials an appropriate focus for any further work which may be necessary.

BACKGROUND

11 ECGD was set up in 1919 to promote exports. Its services have continually expanded and become more sophisticated, most rapidly since the 1950s. The heart of the business is a self-supporting export insurance scheme covering traders and bankers against bad debts. Such insurance gives exporters more confidence in expanding their trade; helps to reduce their costs by limiting the provisions they need to make for bad debts; and encourages the banks to provide competitive export finance. Premiums are charged, with the aim of covering claims and administrative costs. The Exchequer stands behind the scheme in case of need and is currently funding a temporary cash flow deficit, at appropriate interest rates. Insurance is given either on a "commercial" account, after consulting a statutory Advisory Council of businessmen and bankers, or on a "national interest" account by agreement among Whitehall Departments (in a number of cases involving reference to Ministers). All guarantees are given in the name of the Secretary of State.

12 The scale of ECGD's insurance business is very substantial. Some 30% of UK non-oil visible exports are insured and total exposure under all guarantees exceeds £40 billion. There are 1,800 staff: 1,400 at headquarters, split about equally between London and Cardiff, and 400 spread among 9 regional offices.

13 Apart from its insurance business, ECGD handles two public expenditure programmes; an interest support programme for exports on medium and long term credit, and a facility for rapid matching of other countries' aid-supported exports on individual deals. The former has entailed significant expenditure (£329 million in 1983/84) but this is expected to reduce to zero by 1988. Until March 1984 there was also a programme for covering exporters against cost inflation.

14 Over its 65 years of existence ECGD has succeeded in paying its way on the insurance account, though the weight of third world debt now hangs heavily over future performance and has already caused a cash flow deficit expected to last for a further 3-4 years.

15 The UK was probably the first country to create a state scheme for export credit insurance and has since led the way in expanding the range and quality of its facilities. Other countries have followed suit, and there is a wide diversity of national institutions, both in status and range of activities. All have some government backing and are subject to government control on policy matters. There is no obvious paradigm.

PRIVATISATION

16 A few private sector credit insurers and Lloyds operate in the export arena but the market in the UK, though expanding, is fragmented and specialised and totals less than 5% of ECGD's volume. The Matthews Report briefly dismisses the prospects for privatisation. However officials have examined more closely various options (Appendix C). Historically the private insurers have shown relatively little interest in exports. Indeed, ECGD owes its origin and development to the absence of a significant private market in export credit insurance. As in other countries, the UK private insurance sector is not at present interested in small transactions or small exporters - which it regards as uneconomic; or in longer term risks or political risks on payments (eg a new government repudiates

its predecessor's debts, or a country runs out of foreign exchange) - which it sees as too large and uncertain. Consequently the range and quality of its cover stand little comparison with ECGD's. The private market itself disclaims the capacity or the appetite at present to expand significantly. Overall we see no reason to challenge Matthews' conclusion that significant privatisation of ECGD's functions is not a credible option at this stage. Given the need to retain support for exports comparable with that given to the competition, no present alternative can be seen to maintaining something like the existing level of public sector support.

17 The more pertinent question is how the private sector, including the banks, can best be encouraged to play a more significant role in the longer term, in both fair competition and collaboration with ECGD. Joint insurance and reinsurance are the norms in the private sector. The wider use of these techniques by ECGD, coupled with a continuing review of the boundary between private and public sector involvement in both export insurance and finance, would appear to be the best way to encourage the private sector to widen its scale of operation. It might also offer some possibility for ECGD to reduce its numbers in future by concentrating on a more "wholesale" role. This process should be undertaken regardless of the status of ECGD: Matthews implies that it would be easier if ECGD were a corporation with a commercial style rather than a government department, but there is no obvious reason why a change in status should be necessary if ECGD were given a clear mandate and the necessary resources to collaborate with the private sector. As a first step we recommend the setting up of a joint public/private sector working party to explore the practical possibilities. Its terms of reference should require it to identify those types of business and risks for which the private sector could best be expected to provide more cover; and to examine what techniques would encourage them to do so, including co-insurance and re-insurance with ECGD, the possible withdrawal of ECGD insurance in particular areas and the sharing of information.

EXPORT FINANCE

18 Arrangements for the provision of export finance are largely independent of the arrangements for export credit insurance. At present finance in sterling and some other major currencies is drawn almost exclusively from the banks. In the case of medium and long term business they lend at internationally agreed fixed "consensus" interest rates, but HMG, acting through ECGD, pays them (or receives from them) any difference between these rates and their short term borrowing costs plus an agreed margin. The Matthews report recommends against any major change in the system, although it proposes that ECGD should be able to lend directly in certain (unusual) circumstances, and that encouragement should be given to the development of sources of finance independent of government. However it did not review the alternatives in detail.

19 Two broad alternatives to the present system are possible. The first would be for the government itself to provide medium and long term export finance which would undoubtedly enable funds to be raised more cheaply than under the present system but would score temporarily against the PSBR and public expenditure. The second would consist in the creation of an "export bank" which would be largely owned by the private sector but which might have a minority government or Bank of England shareholding: this would avoid the PSBR and public expenditure problems, and minimise the need for over funding, but would be less attractive to the banks than the present system. The second of these alternatives should certainly be explored, whatever is decided about Matthews' main recommendations. Again a joint public/private sector working party would be appropriate for the purpose. The case for considering direct provision of finance by government is less clear cut, but it might usefully be studied by officials and the Bank of England at the same time.

FACTORS RELEVANT TO ECGD'S STATUS

Characteristics

20 The organisation and status of ECGD must pay regard to the tasks required to be performed. There being no scope for substantial privatisation in the near term, the key question is whether those tasks will be more effectively and efficiently discharged by a government department (as at present) or by some other state-backed body. A starting point for consideration might be the main characteristics necessary for the required organisation to be fully effective. We would describe these characteristics as follows:

- A. Unqualified Government financial backing; proximity to Whitehall and Ministerial thinking on trade and foreign policy matters and other related issues; practical arrangements for taking account of the national interest; and easy access to privileged market information.
- B. Clear financial objectives, with necessary controls to safeguard the public purse, coupled with monitoring procedures over the outturn of a wide range of business, to identify and minimise loss-making facilities and avoid unjustified cross subsidisation.
- C. A close relationship with customers (exporters and financing institutions) to allow quick responses to their needs, consistently with the financial and other business objectives; and interaction with private insurers, to promote private sector participation.
- D. Efficient management and deployment of resources at the operational level. In particular management should be free to acquire, organise, and locate the resources of

personnel and machinery, including new technology, strictly in accordance with the needs of the market place, to provide customers with the service they deserve for the premiums they pay.

The Present Arrangements

21 The present arrangements show many of these characteristics. ECGD has enjoyed a high reputation at home and abroad as a pioneer in its own field. The advantages of its government department status should not be undervalued: Exchequer backing is clear and unambiguous; the structure of accountability within Whitehall and to Parliament is well understood; there is easy access to government information on overseas markets; the Department has developed and operated in the context of overall trade policy. Its objectives of encouraging trade without cost to the taxpayer on its insurance accounts have been achieved for over fifty years. The wide range of facilities has enabled some of less certain financial value to be carried without incurring international criticism.

Criticisms

22. Many of those who gave evidence to Matthews, whilst appreciative of ECGD's services, nevertheless felt that the present arrangements fell short of the ideal. Criticisms were varied but the most frequent related to alleged "inflexibility", and slowness of response. The critics tended to associate these shortcomings with undue interference by Government in day to day management. The split of ECGD's headquarters between London and Cardiff, as part of dispersal policy at the time, is the most often quoted example of such interference, with arbitrary staff cuts mentioned nearly as often.

CORPORATION STATUS?

Management Issues

23 In recommending a change of status for ECGD, the Matthews Committee themselves were unable to point to any one overwhelming argument, but referred to "a number of factors which all point in the same direction". These factors appear to revolve round the perceived

need for greater managerial freedom, a desire for more transparent accounting, and a sharper distinction between "commercial" and "national interest" business.

24 However the arguments for change are by no means clear-cut. In particular, the criticisms of ECGD need to be analysed with some care. Many allegations of inflexibility tend to boil down to a plea for greater risk taking at the taxpayer's expense, and thus amount to a demand for a looser financial objective, which Ministers if they so wished could agree within the present Departmental arrangements. On the accounting side, greater clarity of objectives and more rigorous accountability are very much in line with the Government's financial management initiative and with pressures to improve public accountability but Matthews may have ignored the fact that internationally, a degree of opacity in published accounts may on occasion be to the UK's advantage. Moreover, a corporation on the lines suggested by Matthews, with a capital structure to service, could well find itself providing a more efficient, but a narrower and more expensive service than ECGD. On managerial issues, where Matthews' and other criticisms might carry greater weight, the transitional problems of a change of status (which would be opposed by the Unions) may have been underestimated, and any efficiency gains would only be reaped over the longer term. However, the Matthews report did not specify the managerial changes which were needed.

Financial and organisational Issues

25 A decision to opt for a public corporation with Government backing would require primary legislation, which would be opposed, and would raise fundamental issues of finance and organisation (Appendix D). Some difficult questions of competition policy would also arise. Matthews assumed that a Corporation could retain the ultimate backing of the Exchequer but operate on a day to day basis with greater commercial freedom than ECGD now has. But if the Government were the ultimate guarantor, it could not give the Corporation a completely free hand. We observe that, whatever the

status of credit insurers in other countries, some of whom are corporations, they have little freedom over policy.

26 The costs and benefits of a public corporation compared with the alternative "departmental" option depend on decisions about four interlinked issues:-

- (i) the nature of the "reinsurance" arrangement between HMG and any corporation;

- (ii) the nature of the underlying guarantee given by the Government to the Corporation's own account business (ie that not reinsured);

- (iii) the size of the capital base needed to support the operation; and

- (iv) the nature of the controls which would be needed given that the Government is the ultimate guarantor and owner and the provider of funds to support export finance at fixed interest rates.

27 A number of alternative structures could be devised. The limiting cases are probably those of

- (a) a corporation with a purely commercial remit ie business limited to buyer risks and "good" political risks. A corporation on these lines would be smaller than ECGD with a small capital base. Even so, it would be unable to dispense with a Government guarantee completely and this would detract from a fully commercial approach. The arrangements for division of risks could be distinct and well defined, making for clearer accountability. This would be the logical choice if privatisation was the ultimate objective. The remaining business covering the more obvious risks, would fall to the Government's account. The corporation would handle these on an agency basis but a sizeable

establishment in the sponsor Department would be needed to carry out country risk analysis and underwriting;

(b) a large corporation taking almost all the risks now underwritten by ECGD. Making the maximum use of the corporation's resources in this way would reduce the need for duplication of effort within Departments. Such a corporation would however need a very large capital base and/or a more explicit Government guarantee. The more open-ended nature of its risk portfolio would require a different form of supervision by Government and appropriate departmental staff for this purpose.

In no conceivable case would a corporation be able to take on to its own books the full range of risks currently carried by ECGD. If Ministers wished in the national interest to support risks considered unacceptable for the corporation's own books, some split of the work and of responsibility between the corporation and the Government is inevitable.

28 Whatever alternative for the split of risks and responsibilities between Government and corporation were adopted the central issues would remain the same:

- (a) the basic contradiction between Government backing (and protection from bankruptcy) and a truly commercial approach;
- (b) the need for controls to protect the Exchequer and taxpayer as ultimate guarantor and the consequential limitations on management's freedom of action;
- (c) the immediate PSBR and public expenditure cost of endowing the corporation with a capital base;
- (d) the extent of any improvement in financial discipline and public accountability;

(e) the extent of duplication between Government and corporation arising from decisions on Government account business and supervision of total contingent liabilities;

(f) the extent of any improvement in efficiency of service to the exporter;

(g) the possible contribution to the development of the private sector.

Matthews' Recommendations

29 Altogether a change to a corporation is a feasible, but by no means easy, option. The less tangible gains looked for in terms of improved efficiency, financial discipline and service to exporters would need to be weighed against the certain cost of dislocation caused by change, of the capital base endowment, and of the split of responsibility and effort between corporation and Government. The judgement to be made is whether the alleged weaknesses in the present system which need to be rectified are sufficient to justify radical change, or whether sufficient improvements are capable of being made within the present framework. The case for a change rests to a considerable extent on Matthews' belief that a government department cannot provide the kind of management and staffing regime needed for a fully commercial operation.

30 ECGD, for its part, welcomes the emphasis in the Matthews Report on greater discretion in such areas as recruitment of staff and deployment of resources of manpower and machinery. All Departments support the proposals for greater clarity in financial objectives and responsibilities. The Central Departments, however, do not believe that Matthews' itself or subsequent consideration by officials has yet demonstrated that the managerial advantages claimed from public corporation status would offset the costs identified in paragraphs 27-29 above: they believe that the precise managerial and related changes desired must be specified and evaluated before concluding that these could only be secured by a radical change in status and not within a continuing departmental structure.

31 Both ECGD and the other Departments have concluded, therefore, that these issues and the scope for changes within the existing Departmental structure, particularly in the context of the Financial Management Initiative and related developments, should be examined further. Partly in response to FMI, ECGD is already well advanced in developing and refining its business and financial objectives, and in piloting new technology. Closer scrutiny and control is being exercised over the financial outturn of individual facilities, and Ministers have agreed tighter guidelines for risk taking and subsidies in the more doubtful markets. If Ministers desired, these developments could be pressed further and faster.

32 The kind of changes that ECGD believe will be necessary to improve their efficiency and effectiveness and to impart the more businesslike approach regarded as desirable by Matthews lie mainly in its operational systems and in its ability to recruit, motivate and retain staff of the required background or experience in competition with analogous institutions.

33 They and the other Departments concerned therefore recommend that an immediate examination of ECGD's management system and operations should be undertaken by a Review Team led by ECGD at senior level, reporting to a Steering Group chaired by the Secretary. It might include businessmen of proven ability in fields relevant to ECGD's operations as well as representatives of the Central Departments and would be able to buy in, where necessary, advice on specialist topics eg information technology or management systems. The examination should begin in October, with a view to making specific recommendations to Ministers by the end of the year. The scope of such an examination might include, for example, the creation of a special grade of underwriters, the development of payments by results schemes, the infusion of commercial talent at appropriate levels into ECGD, and revised procedures for handling short term and project business. But these and other possible developments would be for consideration by the Review Team.

APPENDIX A

RECOMMENDATIONS OF THE REPORT OF THE MATTHEWS COMMITTEE

The Matthews committee summarised the evidence they received as follows:-

1. The services ECGD provides are widely used and appreciated by the United Kingdom's exporting community, although there were criticisms;
2. The quality of credit insurance and financing facilities in general compared favourably with those available to competitors in other countries, although greater flexibility and cooperation with the private sector should be encouraged;
3. A number of factors associated with the Department's status and activities as a government department hinder its efficient operation;
4. There is a widespread feeling that some change in the way the Department operates is now desirable, provided that the change does not disrupt its on-going activities;
5. At present it is not practicable to devolve ECGD's activities to the private sector, in whole or in part.

Accordingly they recommended that:-

1. ECGD should be replaced by a government-owned corporation, suitably capitalised, which should retain close links to the centre of government. Its activities should embrace all those now being carried on by ECGD;

2. The corporation's guarantees should have, and be seen to have, the full backing of Her Majesty's Government;
3. The purposes of the corporation should be to provide insurance and financial services in support of exports, and to do so at a profit;
4. The corporation should have a board of directors, with statutory responsibilities, replacing the present Advisory Council arrangements;
5. The corporation should invest its reserves as determined by its board;
6. The corporation should be enabled to raise funds in its own right for on-lending in certain situations;
7. The corporation should be enabled to reinsure risks with Her Majesty's Government or with private sector insurers;
8. Its management should discriminate more between one risk and another than the Department now does;
9. The corporation should be paid for administering schemes on behalf of Her Majesty's Government which are outside its normal credit insurance or financing functions;
10. The new corporation would have greater freedom in its management and operations than ECGD believes it has at present. It should use this freedom, and the flexibility it will allow, to develop both cooperation and competition with the private sector insurance market;
11. A number of organisational and operational matters should be tackled by management once the question of status has been resolved.

APPENDIX B

INTERDEPARTMENTAL WORKING GROUPS

Four interdepartmental working groups, chaired by Treasury, Department of Trade and Industry, ECGD and Bank of England, considered in detail different aspects of the Matthews committee's conclusions. Papers on the following topics were submitted by these working groups to the main interdepartmental committee of officials:-

1. The Scope for Privatising ECGD Services -
attached as appendix C;
2. Structural and Financial Implications -
attached as Appendix D;
3. Trade and Competition Policy Issues - summary
attached as appendix E I, full report at
appendix E II, not attached;
4. Export Finance: Alternative Systems - summary
attached as appendix F I, full report at
appendix F II, not attached;
5. Staffing and Management Issues - report at
appendix G, not attached;

6. Management of the ECGD Operation - report at appendix H, not attached;
7. The Export Credit Insurance Market - descriptive note at appendix J, not attached;
8. Comparison of the Major Official Credit Insurance Agencies - descriptive note at appendix K, not attached.

Copies of all appendices are available from ECGD, on request to 01-382/7427/7429.

SRC/AFC/1/8

THE SCOPE FOR PRIVATISING ECGD SERVICES.

NOTE BY THE WORKING GROUP ON ECGD SERVICES

1 As part of their terms of reference, the Matthews Committee were asked to examine "the possibility of devolving any functions to the private sector or collaborating with the private sector in carrying them out". Their conclusion on this aspect of their investigation was to dismiss very briefly privatisation as an option for ECGD on the grounds that the private sector had neither the will nor the capacity to take on ECGD's insurance activities. This paper therefore examines some of the general background and attempts to analyse in considerably greater detail than appears in the report itself the possible scope for privatising the facilities presently offered by ECGD.

I BACKGROUNDECGD's Activities

2 For the 65 years of its existence, the heart of ECGD's business has been insurance to exporters and bankers against bad debts. Losses can arise from 'commercial' causes (the buyer cannot pay) or 'political' causes (default by a Government buyer, or inability of a Government to pay foreign exchange). Traditionally such insurance, especially against political risks, has been too hot for the private insurers to handle, and the UK was one of the first countries to introduce a state scheme. The major exporting nations followed suit and, more recently, schemes have mushroomed in the third world, in many cases with technical advice from ECGD. All of them aim to break even.

3 From small beginnings, the scope of ECGD's cover has been progressively widened. Cover to exporters has been supplemented by unconditional guarantees to financing banks to ensure the availability of export finance at the best (in some cases subsidised) rates, and a range of ancillary facilities has been devised to support exports of major capital goods.

4 The scale of ECGD's business is now substantial. Some 30% of UK visible exports (other than oil) is covered and the total amount at risk under all current

guarantees exceeds £40 billion. Insurance is given either on a 'commercial' account, on the advice of an Advisory Council of businessmen and bankers, or on a 'national interest' account by agreement with Whitehall departments. Both accounts are subject to the financial objective to break even in the longer term on the insurance operations.

International Comparisons

5 As the separate papers on overseas credit insurers (OCIs) shows, there exists a certain fundamental similarity across the various institutions in that virtually all are government-backed and very few enjoy any real degree of independence in policy matters. Apart from the UK, only the Japanese operate entirely through a government department. Of the eight major OCIs no two are alike, varying from a private company operating as an agent of government (Hermes - Germany) to a state bank operating for its own account (Eximbank, USA). However most major OCIs, for example Hermes (Germany), Eximbank (USA) and EDC (Canada), are able to exercise a considerable amount of autonomy in day-to-day management matters.

6 On many more aspects, there exists a considerable degree of diversity. The UK, French and Japanese agencies all insure approximately one third of their national exports, but no other organisation operates on such a scale. The Italians come next with about 16% of exports, with the remainder covering less than 10%. Private sector insurance of exports is available in several other countries but nowhere does it underwrite any significant political risks on its own account and nowhere does it cover more than a tiny percentage of export trade (except possibly for the USA, the UK private market with 1-1½ per cent is probably the largest). The range of risks covered by the private sector is fragmented and varied but is probably larger in the UK than elsewhere. In addition, some overseas payment risks are carried by banks in all countries. Many exporters obviously self-insure, presumably because they perceive little risk in their own case.

7 Most export credit institutions have forged close links with the export financing mechanisms, in a variety of ways. ECGD guarantees repayment of funds mobilised by the private sector, at a guaranteed rate of return. In Germany, on the other hand, most export finance is provided by the banking system at strictly commercial rates of interest even for medium term credit which may sometimes be

supported by the assignment of Hermes credit insurance. In Japan the Export-Import Bank, (like the Eximbank in the USA on which it is modelled) mixes official funds with commercial money to support exports on medium to long credit terms.

8 The form and development of the various State-backed bodies obviously has been influenced by the environment in which they are required to operate, and the policy needs of the countries concerned, as perceived by the Government of the day. In sum, there is no obvious, ideal model against which to assess the best export support system for the UK, although OCI experience can be a guide in suggesting the range of alternatives.

II PRIVATISATION

Definitions

9 In discussing the subject of privatisation, it would be useful to define the term in the context of export credit support. In its conventional sense, privatisation is understood to mean the transfer to the private sector, via a stock market flotation or other form of sale, of a controlling interest in the existing assets and liabilities as well as the functions of a publicly-owned organisation. For the purposes of this paper, the privatisation of ECGD services is taken to encompass only the functions: that is, it refers to government disengaging from all (or an identified portion) of the services ECGD now provides, leaving them to be taken up - or not - by the private sector. It is assumed that the existing liabilities of ECGD would remain to be administered by the Department or Corporation until they were discharged; any "selling off" of these would, in practice, amount only to reinsurance, since the guarantees themselves could not be unilaterally transferred.

The Options

10 At present, ECGD is a Government department providing export services in the UK over which it now has a virtual monopoly. There is a small private market in export credit insurance but, although it has always been free to compete with ECGD, and probably could have done so in some areas such as short term business, as the evidence the Matthews Committee received from a variety of sources showed, it has serious limitations both as to capacity and breadth of cover. (See

separate paper). Many users of ECGD services have expressed their concern that if the Department's most successful activities were allowed to be picked off and privatised this would unbalance the remaining portfolio, leading to a vicious circle of falling business and rising premiums. Private sector insurers themselves told Matthews they could not foresee their replacing ECGD, particularly for exports on longer credit or to markets where "political" risks are significant, and because of the sheer scale of the business.

11 Despite the evidence to Matthews, privatisation at some stage is an intriguing possibility. We are constantly told that London is one of the world's most developed and sophisticated insurance and financial centres. The banks claim to have increased their medium term overseas lending at their own risk. The insurance market is heavily involved in domestic credit insurance, and the range of export credit insurance available in the private market is growing, though it is still small. The fact that ECGD has covered a steady one-third of UK visible exports for a number of years and has managed so far to operate on a break even basis suggests that there might be scope for significant privatisation in the longer term if others were to offer a wide enough range of facilities. However the scale of recent political claims and growing concern about sovereign risks casts doubt on this presumption. This raises two questions: what is the private sector capable of offering now, and how might greater private sector participation best be encouraged?

12 As the accompanying paper shows, the existing private sector's current activities are tiny compared with ECGD's; they are more specialist and discriminating in their availability and are best regarded as complementary to, rather than competitive with, ECGD's facilities. Even Trade Indemnity (TI), the most important and longest established of ECGD's "competitors", especially in the short-term field, have never expressed a wish to be widely competitive with the Department. Instead, they seem to want assistance in winning ECGD's best short-term business by the Department actually ceasing to provide cover for some transactions in the EC and USA. Such selection would affect premium rates for the rest of ECGD's business adversely (but see para 18).

13 In spite of the difficulties, three options for privatisation might usefully be examined. These are:

- i) The closure of ECGD;
- ii) The transfer of ECGD en bloc to the private sector;
- iii) Partial privatisation of particular functions to assist the development of the private sector.

The Closure of ECGD or its transfer en bloc to the Private Sector.

14 Since the arguments relating to these two options are very similar, they are considered together. The only real difference would be an organisational one: option (i) would be likely to lead to the rapid fragmentation of export credit support as different organisations took up elements of ECGD's past activities whereas option (ii) would involve the transfer of the existing Department as a complete unit into the private sector. Effectively however, the success of either route would depend on whether the city institutions could be stimulated to meet the level of demand for cover if HMG withdrew from export credit insurance completely.

15 Certainly, the challenge would be formidable and Matthews, reinforced by the views of the private sector insurers themselves, was clearly sceptical about their ability to rise to it, even in the longer term. Given the major differences of scale and approach mentioned above, this scepticism is well founded. The capital that would be needed to provide a service similar to ECGD's would be vast and even if it could be found, its providers would expect a rate or return significantly greater than could be made compatible with an efficient, consistent and economical service to exporters.

16 Overall, either option would seem likely to lead to a significant cut-back in marginally profitable services with consequent problems for exporters who would find the availability of support fragmented, if in existence at all. Moreover, the cost of those facilities remaining available would probably rise considerably. This would price many exporters out of the credit insurance market completely and impair the competitiveness of those who remained able and willing to pay for cover. Those exporters transacting business on short credit terms and in the less

risky markets could probably obtain insurance or create an adequate internal reserve for bad debts. The banks would also no doubt finance those exporters who were themselves judged creditworthy. But there must be serious doubt about the position of many companies selling on longer terms or to riskier markets. This would inevitably lead to some worthwhile exports being lost and it could cut a swathe through those capital goods industries which depend heavily on ECGD guarantees to encourage the banks to make available medium and long term export finance equivalent to that provided by major competitors' countries. The banks themselves have questioned the security that could be obtained from a private sector insurance guarantee from a number of aspects (see Private Sector paper). Withdrawal of ECGD support would also hit all those companies, not least the smaller ones, trading with the third world and for whom the Department's support is crucial.

Partial Privatisation

17 In practice, and for the reasons mentioned above, this is likely to mean initially giving the private sector access to some of ECGD's best business by means of the Department simply withdrawing from it. This might be considered a useful way of encouraging the private sector to start increasing the volume of its present activities and to gradually increase its capacity and range of facilities, both currently very restricted, eg by combining commercial and political risk cover. In theory this gradual approach might avoid, or at least minimise, the substantial dislocation to trade likely with either of the first two possibilities and help to identify clearly those areas of export support where government involvement is not essential. Although, even in the longer term, the private sector would be interested probably only in the most attractive few percent of ECGD's business and not any one facility as a whole, this might have the benefit of injecting an element of competition into those facilities at the margin offered both by the Department and in the market.

18 However, there are several aspects of the financial impact of this course on those activities remaining with ECGD which need further examination. As the private sector were allowed to take away ECGD's best business, premium increases would be needed progressively on the remainder to compensate for the reducing spread of business. From a national interest standpoint, it could be argued that

the economically sensible route would be to let the private sector assume what it can even if this does have the consequence of raising rates all round for remaining ECGD policyholders who might then be paying premiums more closely related to the risks insured. The reducing spread of business would also reduce scope for cross-subsidisation; in some ways this too would be defensible if it reduced the subsidisation of business in risky markets by that in safer ones. But against this, it must be remembered that a balanced portfolio is essential to all insurance operations. To unbalance it unduly in an arbitrary way would be to strike at a fundamental principle of insurance and when premium rates rose as a result, or if they became wider spread, there would also be a conflict with the trade policy objective of maintaining the competitiveness of UK exporters across the whole range of markets. Further, if ECGD's rates were wider spread it would be more difficult for the private sector to cream off the better business in straight competition and the sheer size of ECGD's portfolio would give it an advantage.

An Alternative Approach

19 An alternative to this approach might be to seek to encourage the private sector gradually to expand the scope of its activities so that it became more involved in supporting the whole range of UK exports rather than pursuing on a selective basis the minimal-risk business. This would have to be done initially through ECGD sharing in the risks new to the private sector, for an initial period at least. One method of doing this would be offer coinsurance opportunities to the private sector; another obvious mechanism would be to provide them with reinsurance facilities or to reinsure some risks with them. This latter collaborative technique is an essential and widespread ingredient of the insurance market, for smaller risks as well as large ones, and arguably offers a better long term prospect of increasing capacity and developing particular areas of business than competition alone.

20 To progress this, discussions between ECGD, representatives of the private insurers and perhaps also the DTI would have to take place. There would be various technical difficulties to overcome, but they should not be insurmountable given goodwill on both sides. However, the process would be slow and for it even to begin in those areas it would have to embrace to be worthwhile - notably political or longer term risks - there would have to be a sea-change in the private

sector's attitude to the UK's overall needs. Another difficulty that could arise concerns overall costs to exporters. If ECGD offered reinsurance facilities to the private market, charges could rise, at least in the short term. Also ECGD's total exposure might increase.

Conclusions

21 In summary, although it may be possible to encourage the private sector to develop and expand to the extent that it might be able to compete with at least some ECGD services to an extent significant in national terms, this seems some way off. There therefore seems no reason to question the Matthews Committee's conclusion that there is not, for the present at least, much scope for privatisation. The private sector could not provide a competitive insurance service for UK exports if ECGD facilities were rapidly withdrawn. Even so, despite much evidence which points to the limited development and capacity of the existing private market, and the need for a strong government role in export support, the private sector may have a useful contribution to make and greater collaboration with them through reinsurance could be the first step towards partial privatisation. To this end, discussion should begin with representatives of the private sector insurers. Although any major replacement of ECGD's facilities by the private sector seems to be a long way off, two-way benefits may begin to flow from closer collaboration, but while the governments of our main trading competitors continue to involve themselves so deeply in support for exports a cautious step by step approach will be appropriate.

M/17/7/84/2

MATTHEWS COMMITTEE FOLLOW-UP

STRUCTURAL AND FINANCIAL IMPLICATIONS

NOTE BY THE WORKING GROUP ON STRUCTURE AND FINANCE

1. This note examines the structural and financial implications of the recommendations in the Matthews report. It does not seek to consider alternatives such as privatisation or improvements within a departmental status, which are to be covered elsewhere. The principal areas covered in this note are:-

- (i) The division of business between the proposed Export Credit Guarantee Corporation ("ECGC") and the Government (paras 3-11)
- (ii) the treatment of business underwritten for the Government's account (paras 12-18)
- (iii) the treatment of public expenditure programmes (paras 19-20)
- (iv) the structure, financial organisation and staffing implications of ECGC (paras 21-42)

2. The critical decisions in setting up a new Corporation will be the definition of the functions that it performs on its own account and those performed on behalf of the Government, the split between these and their financial and administrative treatment. These areas are therefore covered before questions relating to the detailed structure and organisation of the Corporation.

DIVISION OF BUSINESS BETWEEN ECGC AND THE GOVERNMENT

3. Because of limitations imposed either by its capital structure or by the more stringent financial remit to which it would be working, ECGC would be unable to take on its own "book" the full range of risks currently handled by ECGD. It is, however, assumed that Ministers would still wish, in the national interest, to continue to support certain risks considered uninsurable by ECGC. The Matthews report suggests that the Corporation could enter into reinsurance arrangements with either private sector insurers (where the risks were commercially insurable and where the Corporation was constrained for capital or

portfolio reasons) and with the Government (where the constraint was the uncommercial nature of the risk). The need for, and extent of, insurance with the private sector would be a business decision to be taken by the board of i to be weighed against other options, such as requesting an increase in the Corporation's capital.

4. The arrangements for dividing the risks between ECGC and the Government would need to be specified from the outset. The definitions of political and buyer risk used, and the distinction between them, will be critical, and will need to be clearly established so that each cause of loss is clearly attributable to either the Corporation or the Government. Matthews proposes that the arrangements between ECGC and the Government should take the form of Treaty Reinsurance, the term used in the insurance market for an arrangement under which certain pre-determined risks are automatically passed back by the primary insurer to the reinsurer. Whatever the term used, a permanent framework for handling these risks would be essential since it would be impractical for ECGC to pass back to the Government, on an ad hoc basis, each case with risks which it regarded as commercially uninsurable. Defining in advance the precise areas of risk to be covered by ECGC and the Government poses considerable difficulty, and there are a number of possible approaches to this division of risk. Four of these are analysed below.

5. Option 1. ECGC would take on all risk that it considered commercial. In practice, this would probably mean that all buyer risk (except perhaps very large one-off risks which might unbalance its portfolio) would be for ECGC's account. The Government would therefore only assume buyer risks for cases which were exceptional due to their size or non-commercial cases where it was decided to support the risk despite security viewed by ECGC as inadequate. Some political risks, such as those on 'D' markets would clearly be for the Government's account; others are not so clearly or easily attributed to either account, and their distribution would require specific negotiation between the Corporation and the Government. This might result in the risk on individual markets within the same grade being allocated to different accounts and/or the amount of overall exposure on individual markets being shared between the two accounts (with ECGC taking political risk up to a predetermined amount and the Government the balance). The perception of the nature of risk on individual markets will change over time, and, under this option, there would therefore need to be a fluid arrangement between the Government and ECGC so that the

distribution of risks, for new business, between the two accounts is changed either in accordance with ECGD's view of what, at any time, represents a commercial risk, or as the result of agreement between ECGC and the Government.

6. This option would leave ECGC free to take on the widest possible range of risks, and thus the maximum amount of business, that it considers desirable (constrained only by its capital structure and the need to meet its financial objective). The maximum use of the Corporation's resources and expertise would tend to reduce the need for duplication of effort by the Government. However, any division of risk between the Corporation and the Government will produce problems at the borderline, and a fluid borderline will accentuate this. Such a division of risk will also, as with the other options below, produce a split of responsibility for export credit policy.

7. Option 2 This would be an arrangement similar to that of COFACE in France, under which ECGC would underwrite buyer risks only. This might be expanded to cover a very limited and clearly defined level of political risk (such as for short term business in A and B grade markets only).

8. This option has a number of advantages. Under this, the risks to be covered by the Corporation or by the Government would be distinct and unchanging over time. This would make for much clearer public accountability and would make ultimate privatisation much easier. The Corporation would tend to specialise in the analysis of buyer risk, and the Government would tend to provide most of the country risk analysis although there would still be some duplication of effort. The risks covered by the Corporation would be unquestionably commercial; the achievement of its financial objective should therefore be much more within its control than if a range of less predictable political risks were to be underwritten. The main disadvantage would stem from the need to establish within Government a sizeable establishment charged with the operation of the political risk account. It would also limit the effect of any benefits from public corporation status (although the agency arrangements discussed below could also apply).

9. Option 3 A split of risks between the Corporation and the Government on the lines of the present Section 1/Section 2 split. This would reflect the commercial/national interest split of the existing arrangements, even if, in practice, this might not be very different from Option 1. However, the existing

system normally covers an individual case on one account, and this would minimise the inevitable complications where risks on a single policy were allocated between the two accounts.

10. Option 4 The Corporation would assume all the present ECGD risk portfolio except those risks which are obviously inconsistent with its financial objective or capital structure. This would reflect the break-even objective of all ECGD's existing insurance business, and would allow the maximum scope for the effect of benefits from public corporation status. Under this option, the presumption would be the opposite of that in Option 1, so that all business accepted for the Government's account would need to be specifically justified, rather than the Government automatically accepting the balance of risk. This would clearly have an impact on the capitalisation and financial objective of ECGC, but there is no obvious logic in the Government setting up a Corporation with a capital base and/or explicit Government backing, and then retaining the bulk of the business itself.

11. All of these alternatives involve some split of business, and hence of responsibility, between the Corporation and the Government. This is likely to lead to some additional cost (which must be met by the exporter or the taxpayer). Clear arrangements will be needed to define the relative responsibilities of the two parties. The perceived benefits, for each alternative, of public corporation status, will therefore need careful consideration.

THE TREATMENT OF BUSINESS UNDERWRITTEN FOR THE GOVERNMENT'S ACCOUNT

12. Under all the alternatives covered above, a range of risks would remain to be covered by the Government. From a practical viewpoint, it would be sensible for the Corporation, in respect of those guarantees partially or fully undertaken by Government, to perform not only the administrative functions - issuing the policy, collecting premium, maintaining records, processing and paying claims - but also to have an underwriting authority within delegated powers granted to it by the Government. The arrangements could therefore provide for:-

- (1) a reinsurance agreement to be entered into between the Corporation and the Government defining the precise risks to be carried on each account. This would be subject to periodic review and would provide for case by case treatment of exceptional cases (eg inordinately large buyer or political risks);

- (ii) the Corporation to be given delegated authority from the Government to underwrite Government account business within predetermined limits;
- (iii) the Corporation to process all applications for cover falling within the delegated authority and to issue a single guarantee in its own name covering the full range of risks;
- (iv) the Corporation to notify Government of risks so underwritten and to pass back to the Government the premium collected by it relating to the Government account risks¹;
- (v) the Corporation to process all claims and to be authorised to admit liability where applicable, on behalf of the Government account and to meet such liability out of funds granted to it by HMG¹.

The main feature of these arrangements is that the Corporation would effectively act as the Government's agent, recovering its costs directly or indirectly from the exporter.

13. The level of premium charged for risks insured for the Government Account would, however, need to be determined by the Government. Premium rates would continue to be set at a sufficient level to cover costs, ie underwriting losses, cash-flow costs and administration expenses. To arrive at appropriate premium levels for each class of risk a premium review process, such as that currently conducted by ECGD, would need to be operated by the department responsible for the Government account. Initially, rates would probably have to be those presently charged by ECGD for the same business or, where the risks are split between the Corporation and Government, an agreed part of it. Fine tuning of the rates will only be possible in the light of actual experience of the trading performance of the Government account.

14. Accounting The financial management of the Government account would be the responsibility of the department on whose behalf the Corporation issued guarantees. Since DTI seems to be the obvious sponsor department for ECGC, it would be logical for the Secretary of State for Trade and Industry to continue to exercise the powers to give guarantees in the current Export Guarantees Act, subject, as before, to the consent of the Treasury, and therefore for the DTI Accounting Officer to be responsible for the Vote covering both the administrative costs, premium and claims payments on the account together with

¹ The attribution of premium income and claims payments to the two accounts would depend on the designation of the risks at the time when the cover was underwritten.

any trading fund account (see below) and for the department's judgement of risk on the business taken onto the account as well as for the propriety of payments and the efficiency of its organisation, including the agency arrangement with the Corporation. The PAC could be expected to enquire into these aspects. In addition, but probably of less significance in resource terms for the department, would be the exercise of sponsorship functions in relation to ECGC including negotiation of the Corporation's external financing requirement, accounting for funds advanced to, or received from, ECGC (eg NLF loans), scrutiny of corporate plans, etc.

15. A more complex issue is whether the "programme" should be classified as public expenditure or as a trading activity. International considerations - the need to show transparently that the scheme meets the GATT prescription that the premium charged is sufficient to cover costs and that the scheme is not operated as a subsidy - might suggest that it should be operated as a trading activity against a break-even financial objective requiring the production of annual Trading Accounts subject to audit by the National Audit Office. This might, however, ignore the nature of the risks covered by the Government account. In terms of the balance of the portfolio, these would be all the political risks and those buyer risks which could not be accommodated by the Corporation. Though ECGD's experience suggests that, except in certain narrowly defined circumstances, substantial loss is not suffered due to the occurrence of political risks, this may well not hold good for the future. The unpredictable nature of the risk and the long periods of exposure suggest that the account might be more appropriately operated as a public expenditure programme. This view would be reinforced if the Government account would carry only those worst political risks which the Corporation was unwilling to take on its own account.

16. Departmental Responsibility for Risks The Matthews report suggests that departments sponsoring individual non-commercial cases should bear any eventual costs of this business on their own Votes. A particular example of this would be 'sharp' arms business, which is not covered by most of the international agreements covering the terms of export credit, and which ECGC is unlikely to see as commercially insurable. The Group takes the view that, while it would be desirable to implement the report's recommendation, this does not seem practicable. Effective attribution of responsibility would mean bringing this within the Public Expenditure Survey (PES) arrangements, but the liabilities underwritten will normally stretch well beyond the PES horizon. It is also often

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difficult to identify a single department to bear responsibility, since several interests will be involved. In the example of arms sales, industrial as well as defence arguments are important.

17. Interdepartmental arrangements Even if DTI assumes the accounting responsibility for all Government account business, there will still be a need for the interdepartmental machinery provided by the Export Guarantees Committee (EGC). This would continue to consider country limits, decisions to withdraw and restore cover, and individual exceptional cases (with reference to Ministers where agreement is not reached). It would provide a forum in which ECGC's technical and administrative expertise could be brought to bear on issues of export credit policy on which Government departments will be taking the principal role in both domestic and international discussions, and would also allow other interested departments, principally MOD, FCO and ODA, but on occasions also DOE, DEn and DTp, to put forward their views. MOD and FCO are particularly anxious that such a forum should continue to exist. EGC might also play a role in discussing and agreeing with the Corporation any changes in the division of risks.

18. The agency arrangements envisaged above would mean that there was little difference from the existing system for the exporter, since one organisation would continue to administer all insurance activities. There would only be a positive benefit if the arrangements are more efficient or cheaper. The report expects increased efficiency due to public corporation status, but agency arrangements will mean that, unless ECGC is given a degree of freedom that raises questions of accountability and the interests of the taxpayer, its operation of the Government account will inevitably be less direct and immediate than for business for which it is fully responsible. Unless there are significant savings from greater efficiency, there is a danger that the net costs of a split administration of export credit insurance, part of it with a profit objective, might be greater. Either the exporter or the taxpayer will have to bear such costs.

THE TREATMENT OF PUBLIC EXPENDITURE PROGRAMMES

19. Agency Arrangements There are three areas in which ECGC might act as agent for the Government: for reinsured Government account business (discussed

above), for the administration of ECGD's existing subsidy programmes, notably interest support, and for any additional publicly funded advisory or non-insurance services. The report attaches particular importance to the recommendation that the Corporation should retain all ECGD's existing functions, so as to continue to provide 'one stop shopping' for exporters. While such agency arrangements are quite feasible, and would reduce duplication of administration, this does raise important questions of financial control and the extent of delegated authority, given that the sponsor department would retain accounting responsibility. Adequate arrangements for monitoring value for money in these agency operations would be needed.

20. While exporters might naturally prefer to deal with a single agency for credit insurance, export finance and advisory services (and there are clearly close links between them), this is not the general pattern overseas. There is also an inherent conflict of interest between the maximisation of credit insurance business for ECGC's own account and the minimisation of the interest subsidy which it would administer on behalf of the Government, since the access to subsidy would be an important attraction of ECGC's insurance policies. This raises the question of whether the existing link between ECGD credit insurance and access to interest subsidy should be maintained. The question of agency fees raises the problem of additional public expenditure: at present all ECGD's administrative costs are met from premium income, and while the cost of administering the Government account insurance would presumably be met from the premiums charged, this leaves the cost of administering the public expenditure programmes and any advisory services. It might be thought that it was appropriate for exporters to bear these costs.

THE STRUCTURE AND FINANCIAL ORGANISATION OF ECGC

21. The Matthews report recommends that ECGD should become a public corporation. These are defined, for national accounts purposes, as corporate bodies owned and controlled by Government on a basis that is intended to be permanent. Government control is over broad aspects of policy (mainly in relation to capital investment and borrowing, prices, assets and liabilities), and public corporations typically enjoy a wide measure of day to day management autonomy. Nationalised industries are public corporations primarily engaged in industrial or other trading activities, usually deriving the bulk of their income directly from their customers. Their boards are appointed by Ministers, and they

are subject to a broadly consistent set of financial disciplines and controls. Prima facie, the profit making corporation envisaged in the report should be treated for most purposes as a nationalised industry.

22. Statutory basis In line with recent practice for nationalised industries, legislation would define the purposes of ECGC in broad and general terms, and would provide for Ministerial supervision through a suitable combination of general and specific direction powers and consent or approval requirements. The statute would set out the form of Government backing for ECGC's liabilities, and establish borrowing limits and maximum contingent liabilities (such as now apply to ECGD). It would also give the power to set financial targets. New legislation or substantial amendment to ECGD's current Act would also be required to provide for the Government account business, and should similarly restate the purposes of such business.

23. Sponsoring Department DTI would be the logical sponsor for a credit insurance corporation. If, however, ECGC assumed a significant direct export financing role, this might need to be reconsidered. The interests of other departments with an interest in export credit policy would be covered through the interdepartmental machinery discussed above.

24. Structure and Composition of the Board Current practice is to have a Board of no more than 12 members, the majority non-executive. Although the selection of suitably experienced or expert members is generally left to the sponsoring Minister's discretion, specific provision might be made in the legislation. The report recommends that senior officials from DTI and the Treasury should be on the Board: the representation of serving civil servants on public corporation boards is contrary to current practice, and may pose problems of conflict of interest, but might have countervailing advantages in this case because of the very different nature of ECGC. Non-executive members of the Board would not represent specific interests, although a range of relevant experience would no doubt be sought. It would seem appropriate, and consistent with precedent, for Board members to be disqualified from membership of the House of Commons and the European Parliament.

25. Financial Structure The financial structure of ECGC will be critically dependent on its functions, and the volume and type of business currently undertaken by ECGD that it assumes. Before these issues are finally

decided, all that can be suggested are guidelines for a possible financial structure.

26. The Matthews Committee recommended that the Government should stand behind the Corporation. Business reinsured with the Government would carry an explicit guarantee. There is however a problem over the extent of the Government liability for the Corporation's own account business. The Government would be the ultimate owner, and it is inconceivable that the Corporation would be unable to honour its obligations on this business. However the banks and exporters will, we believe, look for a more explicit guarantee. It will be necessary to decide whether to provide for this explicitly in the legislation, or to put the Government's intentions on record in Parliament during the passage of the Bill. It is for consideration whether the Government should charge a fee (to be passed on to the exporter in his premium) for the additional security provided by such a watertight guarantee. There is also a link between the strength of this guarantee and the size of the capital base required. The stronger it is, the less will the Corporation be subject to the financial disciplines stemming from a fixed capital base.

27. Government backing for the ECGC's borrowings and for its credit insurance guarantees could be given in a number of forms: by statutory direct access to the Consolidated Fund, in the last resort (as is now the case for ECGC's insurance guarantees), by a direct Treasury guarantee, by the implicit undertaking enjoyed by existing nationalised industries, or, as is the case for the Canadian Export Development Corporation, a public undertaking to put the Corporation in funds and to make up losses. If ECGC's guarantee is not directly guaranteed by the Government, there is a problem of two different perceptions of quality. But if ECGC can commit the Government explicitly, financial controls will be tighter than for a corporation with only an implicit undertaking. As mentioned above, it is also assumed that there would be statutory borrowing limits and, as now, maximum contingent liabilities. There would need to be separate limits for "own account" and "Government account"/reinsured business. Since the legislation would also give the power to set financial targets, a financial control and monitoring system, on the lines of those for existing nationalised industries would also be set up; this is discussed in more detail below.

28. Treatment of ECGD's existing business There is some agreement within the Group that the best approach would be for ECGC to maintain separate "ECGD" accounts (in the existing form) for all business underwritten before vesting day and would administer this business as agent for the Government. These accounts would be kept until all risks had run off: the distribution of any accumulated reserves between the Corporation and the Government would then be for consideration. Although this approach has obvious attractions, it does raise questions of responsibility and monitoring which will need to be considered further. Alternatives would be for ECGC or Government to take direct responsibility for the existing business, or for each to take part of it, perhaps on the basis of a Section 1:Section 2 split.

29. Capitalisation The report recommends that the Corporation should be capitalised "adequately for its likely needs". It suggests that this will allow greater freedom of action and would encourage a more commercial approach. It is not clear exactly which risks a capital base would be meant to cover if direct Government backing is retained. For the purposes of this note, it is assumed that ECGC would have no direct export financing role: if it did, this might have a major impact on the size of capitalisation required.

30. There are a number of possible approaches to the calculation of a suitable capital base. The size will depend on whether ECGC starts from new or takes over some or all of ECGD's existing business, and on whether the direct backing of Government is intended to cover any unusual cash needs (such as the present debt crisis) or only to operate in the last resort. In the former case, the capital required will effectively be working capital, and may be relatively limited, depending on the size of the Corporation's balance sheet and contingent liabilities; if however, the Corporation is intended to stand alone for all normal operations, it would need a significant equity cushion, which would have corresponding PSBR and PES implications. Pension funding liabilities might also be an important factor in determining the size of the capital base.

31. The size of the capital base will also be affected by the type of prudential supervision envisaged. The only external requirements which might apply to ECGC are the EC solvency margins and these do not seem to be serious constraints. However it is understood that commercial insurers treat these very much as a minimum, and typically seek to increase them by a 100 percent loading. There are no obvious parallels among major credit insurers with which to compare

a directly Government owned Export Credit Corporation. Two possible comparisons are the US Eximbank and Canadian EDC, both wholly Government-owned, but also involved in direct borrowing and lending. EDC, but not Eximbank, has explicit Government undertakings that it will be kept in funds. Annex A compares their capital and liabilities with those of ECGD, and indicates that, to match them, a very substantial capital injection would be required. This would be required immediately if ECGC takes over existing business, but otherwise in line with the development of its business.

32. The composition of the Corporation's capital base would depend on its size and function. It would be normal for this to take the form of a fixed amount of Commencing Capital Debt to the Exchequer: this could consist of interest bearing NLF loans, Public Dividend Capital (PDC) or possibly some form of preference capital. If what is required is essentially working capital, NLF loans would be appropriate: if equity is required, PDC or preference capital would be needed. A large part of such equity capital might be uncalled (as is the case for the World Bank), which would reduce the public expenditure impact without affecting the extent of the Government's commitment. Any initial capital would score as public expenditure in the year of vesting, and any subsequent payment of uncalled capital would score in the relevant year. In any event, the Corporation's capital would not be costless, and the payment of dividends or interest would be required by statute. The scope for possible future privatisation will also affect the structure chosen for the capital base.

33. Financial Control In addition to any statutory limits on liabilities, there would be a detailed system of financial control by the sponsor department. For existing nationalised industries, this is based on financial targets (principally an agreed target Return on Capital Employed) and an External Financing Limit. There is also discussion on, and approval of, each industry's corporate plan. This system would need to be adjusted to the particular circumstances of an Export Credit Corporation: since there would be few fixed assets, ROCE would not be a suitable indicator, and although an EFL might be difficult to enforce, because of the likely volatility of the Corporation's cash requirements, it would formalise existing work on cash planning and setting cash targets for ECGD. But the report recommends that the Corporation should operate at a profit, and there would be an agreed target for this (perhaps expressed as an actual or percentage increase in reserves). There would also be an agreed corporate plan, covering areas such as country limits as well as purely financial

aspects. Arrangements for any "agency fees" for services performed on behalf of Government would also need to be agreed and formalised. The general impression given by the report that the Corporation would have untrammelled freedom of action, yet enjoy the full backing of Government, would be incompatible with the established policy on the control of public corporations. The degree of financial control, and limitations on freedom of action, that would be required to be consistent and to protect the Exchequer would reduce the perceived attractions of public corporation status.

34. Accountability to Ministers and Parliament Arrangements for accountability to Parliament should broadly follow those for the nationalised industries. In general the sponsoring Minister (or Ministers) would answer to Parliament for broad policy aspects but not for day to day management. "Policy aspects" would include in particular justifying the use (or non-use) of any statutory directing powers: and questions concerning performance in relation to agreed financial objectives. The following statutory accountability requirements would probably be needed:

- an annual report to be submitted to the Secretary of State and laid by him before Parliament;
- an obligation to render accounts in a form meeting the requirements of the SOS and consented to by the Treasury. (The British Telecommunications Act 1981 refers to "information to be contained in the statement of accounts; the manner of presentation; and the methods and principles according to which the statement is prepared").
- accounts to be audited by external auditors (either approved by the SOS, or appointed by him in consultation with the corporation). Audited accounts to be sent by a specified date to the SOS, who lays them before Parliament.

The Government is currently considering legislative proposals which will contain comprehensive provisions replacing existing legislation on nationalised industry reports; accounts; audit; appointment, compensation and dismissal of board members; borrowing limits and powers; clawback of surplus funds; reserves; break-even duty and financial objectives; and the creation and disposal of subsidiaries, properties and rights. This will provide a pattern which might be applied to the new Corporation in whole or in part when it is established.

35. Existing public corporations are expressly excluded from the list of Crown-appointed bodies to which the National Audit Office have access. The

National Audit Act (S.7) also excludes bodies which in the relevant year received less than 50 per cent of funds from Government. The establishment of an export credit corporation, which might still be benefitting from explicit Government backing, would therefore remove a significant area of Government expenditure from Parliamentary financial scrutiny. This would not only be controversial in itself, but might well reawaken earlier arguments in favour of extending NAO's scope to cover nationalised industries generally. The NAO will certainly expect to have access to papers relating to Government account business, and is also likely to examine the sponsoring department's monitoring of ECGC's commercial risk.

36. Existing public corporations do not exercise their functions on behalf of the Crown, and are therefore outside the scope of the PCA Act 1957. The PCA does, however, have access where, exceptionally, a non-Crown body performs functions as an agent for a Government department. It is thus possible that ECGC might be open to scrutiny in respect of its agency functions. Whether an export credit corporation would be subject to select committee scrutiny would depend on whether the sponsor department and the relevant Committee agreed that it was an "associated body" of the department for the purpose of the relevant House of Commons standing order. The test - as stated by the Chancellor of the Duchy of Lancaster, on 25.6.79 - is "whether there is a significant degree of Ministerial responsibility for the body concerned". This has been interpreted as extending in principle to nationalised industries, although select committees have largely confined their interest to the broader policy matters on which Ministers would normally answer to Parliament. The Trade and Industry Committee would presumably be the relevant committee if DTI is to be the sponsor department. ECGC might also be eligible for efficiency studies under the Competition Act 1980.

37. Privatisation The report sees little scope for the privatisation of ECGC's business, and this reflects a widely held view. Nevertheless the case for this is being re-examined by the ECGC-led Working Group. The scope for immediate or eventual privatisation of all or part of the Corporation's business is likely to influence significantly Ministers' reaction to the recommendation for public corporation status. In the context of this paper it is therefore necessary to consider whether any particular risk portfolio or capital structure is likely to be helpful in the realisation of such an objective. The risk portfolio which would lend itself best to eventual privatisation would be one where the incidence of loss, the volume of business and the running costs could be predicted with

reasonable accuracy. A pure buyer risk portfolio would best meet this prescription, but even here the relationship between the political and buyer risks in the developing countries may mean that a truly commercial, privatisable portfolio, would perhaps be restricted to the buyer risk in only the more developed countries. For eventual privatisation, the most suitable risk portfolio for the Corporation might be the more limited one described in paragraph 7 (option 2). Alternatively to ease privatisation but to adopt the recommended wider risk portfolio for the Corporation, the truly commercial "kernel" of the Corporation's wider risk portfolio might be underwritten by a separate subsidiary. This would, however, make for a very fragmented and probably unacceptable provision of credit insurance support in any post privatisation scenario - a Government scheme, a private sector scheme and the residual public corporation scheme.

38. If privatisation was seen as a possibility in the short term, the "privatisable" business could be established as a Companies Act Company whose equity was wholly owned by Government. This would then facilitate subsequent privatisation. Companies Act status would not, however, be a satisfactory alternative to public corporation status if privatisation were to be regarded as a longer term objective. If the public corporation were eventually to be privatised, special arrangements would need to be made at the time to achieve this: the structure of the initial capital as between equity and loans, and the form of each, does not therefore need to take account of the prospect of privatisation.

39. Borrowing powers The report suggests that ECGC should be able to finance its cash requirements from either the public or private sector, in addition to any borrowing to fund export finance loans. The Working Group on export finance will recommend that the export financing role for ECGC is one of the options to be considered in a wider review of the arrangements for providing export finance, so that this note will only cover borrowing by ECGC for its own account. Existing nationalised industries have only very limited powers to borrow outside the public sector, and any divergence from this would need to be justified, and could have implications for other nationalised industries. As the Government is the ultimate guarantor, there can be no statutory limit on the Corporation's right to borrow from the Consolidated Fund (or, in the extreme case, to draw money without repayment) in order to meet its obligation. The effective Parliamentary control over such recourse will be by the statutory

control over the amount of business the Corporation may undertake (analogous to the present statutory limits on ECGD's risk). If recourse to the NLF is envisaged a separate borrowing limit would be needed. This will need to be supplemented by a range of administrative financial controls exercised by the Government as part of the corporate planning process, including controls over temporary borrowing and borrowing in foreign currencies.

40. Freedom to invest reserves The freedom to invest reserves within prudent guidelines is seen in the report as an important objective. Public sector organisations are expected to invest their reserves within the public sector, except for short term surpluses, which are treated as fluctuations in working capital. Any variation from this would have implications for the PSBR and would need a strong justification. The ECGC would expect, certainly in the early years, to have cash surpluses to invest and the question would need to be addressed as to whether it should have freedom to invest outside the public sector and whether it should conform to standards laid down for insurance companies in the private sector. If it should be so permitted, expert staff would need to be recruited or bought in.

41. Foreign currency balances There would be a clear commercial logic behind the Corporation being able to accept premia in foreign currencies, and to hold foreign currency balances to match, at least in part, its foreign currency liabilities. Since a Corporation would not be able to deposit foreign currency balances with the EEA, arrangements for deposits outside the public sector would need to be agreed. The use of hedging to reduce or eliminate interest and exchange rate exposures will also need to be looked at. This, too, would require skilled staff, either in-house or bought in.

42. Staff The report envisages that ECGC would take over all ECGD's existing staff, but would thereafter be fully responsible for its own employment and recruitment policy. The transitional arrangements would require careful planning, and detailed legal advice, but would need to ensure that employees taken over from ECGD enjoy terms and conditions (including pension arrangements) no less favourable than they enjoy in the Civil Service, unless agreed compensation is to be paid. Pension arrangements, which could have a material impact on the financial structure of the Corporation, would need particularly careful consideration. An aide-memoire on the issues involved in the transfer of staff from the Civil Service is at Annex B, which ECGD have seen. In view of the

importance attached in the report to the benefits of greater freedom of staffing, it will be necessary to work out the structure that such freedom would permit, and to confirm that this could not be achieved without a change of status.

COMPARISON OF NET ASSETS AND LIABILITIES

	UK ECGD £ million			CANADA EDC C\$ million		USA EXIMBANK \$ million	
	31-3-82	31-3-83	(projected) 31-3-84	31-12-81	31-12-82	30-9-81	30-9-82
Capital	-	-	-	350	465	1000	1000
Reserves	668	863	938	185	186	2199	2040
Equity	668	863	938	535	651	3199	3040
<u>Amounts at Risk</u>							
Loans				3580	4445	15802	16565
Guarantees	25530	31768	32944	2189	1928	13457	12153
Total	25530	31768	32944	5769	6373	29259	28718
Equity ÷ AAR (%)	2.6	2.7	2.8	9.3	10.2	10.9	10.6
<u>Amounts at Risk (Guarantees weighted 0.5)</u>							
Loans				3580	4445	15802	16565
Guarantees	12765	15885	16427	1095	964	6729	6077
Total	12765	15885	16427	4675	5409	22531	22642
Equity ÷ Adjusted AAR(%)	5.2	5.4	5.7	11.4	12.0	14.2	13.4

<u>Section 1</u>	<u>1982</u>	<u>1983</u>	ECGD (£ million)	<u>Section 2</u>	<u>1982</u>	<u>1983</u>
Reserves	214	182			455	680
AAR	13264	14285			12266	17483
Equity ÷ AAR (%)	1.6	1.3			3.7	3.9
Equity ÷ Adjusted AAR	3.2	2.6			7.4	7.8

Additional Capital required for ECGD

- (a) for Equity ÷ AAR ratio of 10% £2356 million
- (b) for Equity ÷ Adjusted AAR ratio of 12% £1033 million

This assumes that existing assets are correctly valued. Any write down would directly increase the additional Capital required.

Additional capital required for Section 1 Account (based on 1983 results)

- (a) for 10% Equity ÷ AAR ratio £1246 million
- (b) for 12% Equity ÷ Adjusted AAR ratio £ 675 million

Transfer of Staff

Certain transfers of staff from one employer to another are covered by the EC Acquired^{Rights} Directive 1977 (77/187/EEC) which has no direct force in UK law, but is applied by the Transfer of Undertakings (Protection of Employment) Regulations (1981 No 1704). The Chief Secretary to the Treasury has, however, said that departments should not take any action which conflicts with the provisions of the Directive. Broadly speaking, the Regulations specify that the staff of an undertaking to which they apply are entitled to be transferred automatically when that undertaking is transferred to a new employer, with continuity of employment, and on the same terms and conditions of employment (apart from pensions). Staff may not be made redundant except for 'economic, technical or organisational' reasons connected with the transfer. It is important, therefore, that legal advice should be taken as to whether the Regulations apply to the proposed transfer and whether the Directive itself should be taken into account. All employees have rights to protection against unfair dismissal under the 1978 Employment Protection (Consolidation) Act.

If the Regulations apply and it is thought desirable to change the staff's terms and conditions of service on transfer, this must be done by agreement. One method is

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for the new employer to make offers of jobs to the staff of the undertaking on terms which, taken as a whole, are no less favourable than those they enjoy in the Civil Service. It should be made clear to staff that acceptance of such offers would be construed as resignation from the civil service, so that the staff would not be eligible for treatment under the redundancy provisions of the PCSPS when they transfer. Such a course could be open to challenge if it can be shown that staff are not fully aware of all their rights and entitlements at the time when they make their choice.

If in such a situation the terms and conditions of the new employment are to be less favourable as a package than civil service terms and conditions, it will be for consideration whether staff should be offered compensation for any detriment involved in order to persuade them to agree to the terms of the transfer and accept job offers. It may be desirable to take powers in legislation to make such payments. Although pension arrangements are not covered by the Regulations, the unilateral withdrawal or variation by an employer of pension rights could lead an employee to claim successfully that he had been constructively unfairly dismissed under the 1978 Employment Protection (Consolidation) Act. Compensation for detriment in relation to pension arrangements may therefore also have to be considered.

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Legislation covering a proposed transfer can therefore either provide for automatic transfer of staff on identical terms and conditions under the Regulations (as in the Ordnance Factories and Military Service Bill, Schedule 2) or provide for the new employer to make job offers to the staff on terms which, taken as a whole, are no less favourable than existing terms and conditions of employment (as in the National Audit Act 1983, Schedule 2), although there must be some doubt whether this latter approach would be held by the courts to be fully consistent with the ARD. In either case, the legislation may also need to contain a provision that a member of staff who is transferred, or who accepts an offer of employment from the new employer, shall not be eligible to be treated under redundancy procedures or receive redundancy compensation from the PCSPS. Where the terms and conditions offered are equivalent such a provision may also be applied to staff who unreasonably refuse job offers, but whether this is desirable will vary from case to case and legal advice will be relevant.

Secondment

The use of secondments to aid the smooth transfer of staff to the new public corporation might appear to have some attractions, but these need to be weighed against a number of legal and practical difficulties which might arise if secondment is used in this context.

The general and widespread use of secondments, either initially to man the operation until incorporation or as a longer term means of staffing the corporation with a succession of secondees, does not appear to be appropriate in this case. The work can be continued by ECGD until

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the new corporation is established. When it is established, there will no longer be a suitable department from which secondees could be sent and, more importantly, to which they might eventually return to be redeployed, as the ECGD would no longer exist.

The more limited use of secondment of particular staff to fill particular posts, e.g. to ensure continuity at the outset or as a means of broadening career development, may have a place, subject to three important considerations.

First, staff cannot be compelled to accept secondment against their wishes.

Secondly, the purpose of secondment, (as indicated in paragraph 10277-10279 of the Establishment Officers Guide) is primarily to further an officer's development within the context of a Civil Service career and to increase the efficiency of the service as a whole.

Thirdly, an officer should only be seconded where the exporting Department is confident that they will be able to redeploy him on return, as failure to do so would create a situation in which the redundancy procedures would be triggered resulting in someone (who perhaps may have had no involvement in the secondment) being made redundant.

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Pension arrangements on transfer

Staff who leave the civil service may preserve their pension rights in the PCSPS or may opt to take a transfer value into the new employer's scheme. Preserved pensions are based on the salary level on leaving the civil service, uprated in line with inflation, so that if an employee's pay in the new employment is expected to rise faster than inflation, for example, on promotion, it may be in the employee's interest, if the terms of the two schemes are comparable, to transfer his rights to the new scheme. The transfer payments brought by transferring staff can be used as the basis of a new pension fund, as in the case of the new company, Hydraulic Research Ltd, employing ex DOE staff. If the conditions of transferred staff are to be preserved, including pension arrangements, it is possible to set up two schemes side by side; one, broadly equivalent to the PCSPS, for staff transferring from the civil service, and another, following more closely private sector practice, for new entrants. Transfer payments extinguish the Government's liabilities in respect of the pensions of transferred employees, so any future liability falls upon the new employer.

MATTHEWS COMMITTEE FOLLOW UP
TRADE AND COMPETITION POLICY ISSUES

SUMMARY OF CONCLUSIONS OF THE WORKING GROUP ON EXPORT POLICY

The Group has analysed the following issues as arising from the Report and its recommendation that ECGD's status be changed to that of a public corporation.

1. Implications for Export Support

The Group concludes that, provided there were to be an appropriate framework in terms of the split of risk between Government and Corporation, suitable financial objectives for each book and adequate resources within the DTI for management control, there is no reason why a switch to Corporation status should affect the availability of support for exporters. The issue of status is largely irrelevant to such questions as the continuation of marginal facilities and the ability to adopt a more discriminating approach to premium setting. The key issue in terms of services to exporters is therefore one of operating efficiency. Given the widespread assumption within the exporting community that a corporation approach is the right one, a decision against a change would need to detail how measures to improve ECGD's operating performance could be secured within existing arrangements.

2. Support for Small Exporters

ECGD's further study of the cost of providing support for small exporters leads the Group to conclude that it is not the case that these costs are being substantially subsidised from premium income from larger exporters. The Corporation, if established, should therefore charge small exporters the full economic cost of administering their policies, introducing the necessary increases on a phased basis.

3. Monopoly and Competition Issues

The Group has considered the competition aspects of the position of ECGD and of the new Corporation, including particularly the arguments for and against giving private sector insurers access to Government support on a similar basis to the Corporation. We conclude that Ministers will need to consider how far any initial legislative and structural arrangements that would be required for the Corporation should make provision for greater competition from the private sector in the medium term, while acknowledging the latter's very limited capacity available at present or within the next decade to provide all the cover that exporters require to compete for overseas business.

4. GATT Implications

Provided that Government's intention is to operate credit insurance in a manner consistent with international practice and at least as commercially as hitherto, any new arrangements can be presented as transparent, and that support is not restricted to particular exporters, sectors or markets, no difficulties should arise within the GATT. However if HMG were to act uncommercially on its own account business over time, there could be problems.

5. Consensus Aspects

We would expect the Corporation to act as technical adviser to DTI, which as sponsor department would lead at OECD Consensus meetings with HMT. The Corporation would undertake the notification and consultation procedures within the EC and the OECD Consensus.

6. DTI Resource Implications

DTI's very initial estimate is that a limited number of additional staff would be required if the Department is to carry responsibility for the sponsorship of the Corporation, the management of the agency arrangements and Consensus policy work.

MATTHEWS COMMITTEE FOLLOW-UP

EXPORT FINANCE: ALTERNATIVE SYSTEMS

SUMMARY OF THE REPORT OF THE WORKING GROUP ON EXPORT FINANCE

Background

1 The Matthews Committee's conclusions regarding export finance were:-

- (i) while there would be some advantages in a new export bank in which the Government would have a majority share in joint ownership with the private sector, these would not outweigh the disadvantages;
- (ii) ECGD should be enabled to raise funds in its own right for on-lending in certain circumstances;
- (iii) every encouragement should be given to development of private sector alternative sources of finance.

2 It is the view of the Group that the Matthews Committee did not give the arrangements for the provision of export finance as thorough a review as is desirable. The present arrangements have worked effectively for many years, and there is naturally some reluctance to disturb them. However, there have been a number of changes in circumstances which at least make it desirable to examine in detail the possible advantages and disadvantages of alternative systems.

The present arrangements

3 From the standpoint of the exporter, the present arrangements have been very effective in providing officially supported export finance. An exporter's concern is to have ready access to finance on the best possible terms in order to maintain competitiveness. However, changes in the Consensus arrangements over the past two years have increased the possibility of financing exports in both sterling and foreign currencies at rates below those in the general matrix of rates, and exporters will want so far as possible to be able to take advantage of this opportunity. The present

arrangements do not encourage the provision of finance at purely market rates of interest with official support limited to credit insurance (pure cover). Difficulty has also arisen due to the absence of an official financing institution through which finance could be provided or channelled in circumstances where a buyer's requirement was for a government to government financing capability.

4 From the standpoint of HMG the present arrangements have four principal drawbacks:-

- (i) By providing long-term export finance through the banking system, the arrangements work unfavourably for monetary policy, and contribute substantially to the need for over-funding.
- (ii) The present arrangements do little to encourage the use of pure cover, and hence to minimise public expenditure on interest subsidies. The costs of subsidy are, in addition, unpredictable, at least for foreign currency.
- (iii) The cost of raising finance through the banking system is higher - by some £50 mn per annum - than would be the case if HMG funded long-term export credit directly;
- (iv) The contingent liability to the reserves of the "take-out" arrangements is very large indeed, and therefore a potential problem.

5 From the standpoint of the banks, the present arrangements are broadly satisfactory, although some maintain that their remuneration is inadequate. Unless it can be shown that the alternatives are at least as attractive to them, the banks may well be resistant to proposals for changing a system with which they are content, in which they are widely experienced, and which does not present them with administrative difficulties.

The alternatives

6 No single alternative system for providing export finance would resolve all these issues. There are broadly speaking three major options:-

- (i) To retain the present system with or without ECGD having borrowing powers.

- (ii) For Government itself to provide long-term export credit.

This would meet most of the problems described in paragraph 4 above and would reduce the cost of interest support. But it would mean that official export finance came within the PSBR (as presently defined), and would do nothing to foster the growth of pure cover.

This option would therefore pose major presentational problems for Ministers, and is likely to be subject to controls over the scale of funding available, which might outweigh the perceived attraction to exporters of this option.

- (iii) To establish a private sector export bank which might include a minority government or Bank of England shareholding.

As with (ii) this would meet most of the problems outlined in paragraph 4, but its implications for the cost of official interest support are not clear. Even if this organisation were to receive the official interest support now provided to the banks and thus were to be the source of officially supported export finance, it might also be able to provide finance on a pure cover basis. But there is a risk that any form of official involvement - for example by way of a Bank of England shareholding - could result in its lending being regarded internationally as 'officially supported'.

Views of the Group

7 The Group recommends that the options set out in paragraph 6 (ii) and (iii) should be studied further. The outcome of this study would not impinge substantially on decisions on other aspects of the Matthews report unless the creation of an official financing vehicle were to affect the risk portfolio of the proposed credit insurance corporation recommended by Matthews. If Ministers agree, the existence of a study of alternative arrangements for export finance should be covered in any general statement on the Matthews report. A consultative document setting out the range of options might be issued by the Bank if it were thought helpful for the encouragement of public debate.

8 The recommendation for further study is not intended to affect discussions between ECGD and the Treasury about the acquisition as soon as possible of reserve powers to borrow, whether for ECGD or for a successor corporation in line with Matthews' recommendation.



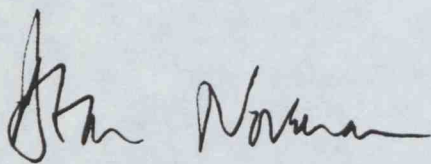
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Treasury Chambers, Parliament Street, SW1P 3AG
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The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
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13 July 1984



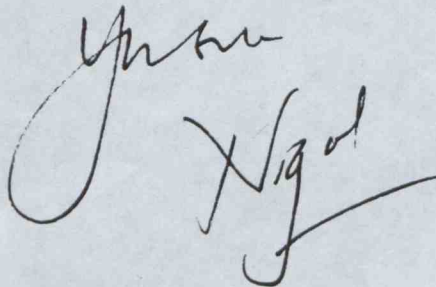
ECGD POLICY TOWARDS RESCHEDULING COUNTRIES

I agree, as you suggest in your letter of 10 July, that the time has come to review ECGD's policy towards countries that have rescheduled their guaranteed debts - as part of the general post-Summit examination of ways of dealing with the international debt situation.

I think, however, that it will be important first to have some discussion with the other major creditor countries. I have therefore authorised Geoffrey Littler to discuss this subject with his colleagues from other Finance Ministries in the course of various meetings in Paris next week, culminating at OECD's Working Party 3.

I hope you will bear with me if I wait for his report from these international discussions, before I respond to your proposals.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and Defence, the Minister for Overseas Development and Sir Robert Armstrong.



NIGEL LAWSON

ELSD

16 JUL 1984

