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PRIME MINISTER

Meeting of E(A) on 17 July 1985

Export Credits Guarantee Department (ECGD)

(E(A)(85) 46 and 47)

BACKGROUND

1. The purpose of this meeting is to consider two related issues:

(i) the outcome of a recent Management Review of ECGD which was set up last year following the unsatisfactory report by Sir Peter Matthews, and is discussed in the paper E(A)(85) 46 by the Secretary of State for Trade and Industry;

Flag A —

(ii) a memorandum by the Chief Secretary (E(A)(85) 47) on the ECGD 1985 Business Plan and measures to strengthen ECGD's financial prospects in the period to 1989-90.

Flag B —

Business Plan and Financial Prospects

2. ECGD has a current exposure of £32 billion and takes on liabilities of around £16 billion per annum. In each of the last five years, it has had a negative cash flow and its cumulative cash deficit with the Consolidated Fund - the measure of ECGD's call on the Public Sector Borrowing Requirement (PSBR) - stood at £342.5 million on 31 March 1985. Between March 1983 and March 1985, ECGD's trading reserves - the measure of its underlying financial strength - fell from £862.5 million to £575.5 million and further reduction seems certain. On a Base Scenario, ECGD's cumulative deficit with the Consolidated Fund is expected to increase to £2 billion by 1990. Other scenarios - Pessimistic and Crisis - show cash deficits of over £4 billion and over £6 billion, demonstrating the sensitivity of ECGD's financial position to the external psoition of the major borrowers. New business is expected to be underwritten profitably, but the impact of cash flow deficits and losses arising from

the old business will persist for some years. This suggests there is little prospect that ECGD will meet the financial targets for size and quality of reserves set by Ministers last year (set out in paragraph 5 of the Annex to E(A)(85) 47).

3. The Minister for Trade and the Chief Secretary have already agreed some specific measures to improve ECGD's financial performance and limit the burden on the PSBR. These are:

(a) premium increases of around 10 per cent from 1 July, particularly for high risk business, with premium levels kept under review;

(b) measures to improve the performance of the comprehensive short-term insurance business (75 per cent of the total) through improved underwriting performance, reduced administrative costs, a new marketing strategy and a better balance of risk exposure of the short-term portfolio;

(c) a continuing review of uneconomic facilities;

(d) refinancing rather than rescheduling claims payments wherever possible (this avoids an immediate addition to the PSBR, although the monetary effects are similar).

4. The Chief Secretary now proposes, on the basis of ECGD's 1985 Business Plan, that:

(a) the Sub-Committee note ECGD's financial position and its consquences for the PSBR, the action already taken to secure the profitability of new business, and the need to keep less profitable business under closer review;

(b) the private sector should be encouraged to increase its involvement in credit insurance business - in the longer term it may prove possible to privatise the separate short-term business which the Management Review recommends should be created;

(c) ECGD's objectives of encouraging exports must continue to be subject to the break-even financial constraint;

(d) ECGD should be instructed to prepare a Corporate Plan for 1986 to give Ministers a range of quantified options for the amount and distribution of risk to be accepted in future;

(e) ECGD's interim objectives should be to underwrite new business profitably, within existing market limits, subject to any agreed changes;

(f) no special arrangements should be made for arms sales, but the 1986 Corporate Plan should take their needs into account.

Management Review

5. On the Management Review, Mr Tebbit concludes that in present conditions privatisation is not an option. He accordingly proposes:

(a) that ECGD's role should be to provide the best service to exporters within the financial constraints agreed by Ministers, while allowing the private market to grow at its own pace;

(b) to reject the Management Review's recommendation for a part-time executive Board: instead, he proposes to fill two of ECGD's Under-Secretary posts from the private sector and to implement the organisational changes over a 3-4 year period;

(c) that flexible pay arrangements be adopted for ECGD, if necessary as a controlled experiment;

(d) ECGD should develop a system of portfolio management for handling political risk (in essence this entails looking at the implications of particular cases for the portfolio as a whole rather than in relation to individual countries).

MAIN ISSUES

6. The main issues are likely to be:

(a) The role of ECGD and possible private sector involvement;

(b) ECGD's future Financial Strategy;

(c) The Government's response to the recommendations in the Management Review.

The Role of ECGD and possible private sector involvement

7. Since he judges that privatisation is not at present an option (the private export insurance sector is still small and would be unable to fill the gap if ECGD withdrew), Mr Tebbit proposes that, within the financial constraints agreed by Ministers, ECGD's role should be to provide the best service to exporters while allowing the private market to grow at its own pace. ECGD must therefore be allowed to market its facilities so as to achieve a balanced portfolio of risks under its break-even remit. The Chief Secretary agrees with this. At the same time both the Chief Secretary and Mr Tebbit wish to encourage the growth of the private sector. The Chief Secretary believes that in the longer term it may be possible to privatise the separate short-term business of ECGD which the Management Review proposes should be established in Cardiff.

8. The role of ECGD as a guarantor of export finance is unlikely to be affected by the work of a group on export financing led by the Bank of England. That is expected to conclude that there is now less enthusiasm in the City for a new institution in export financing, although an increasing proportion of exports may be financed from capital markets by bond issues.

ECGD's Future Financial Strategy

9. The Chief Secretary and the Minister for Trade have already agreed some measures to improve ECGD's financial performance. These are summarised in paragraph 3 above. The general aim of the strategy is to minimise the impact of claims from past business while making new business more profitable.

10. For the future, the Chief Secretary recommends the measures summarised in paragraph 4 above, and places particular emphasis on the need to produce a Business Plan in 1986 that presents Ministers with a range of quantified options for the amount and distribution of risk they are prepared to accept in future. This in turn is linked closely to the proposals in the Management Review for portfolio management, which should help ECGD to attain the objective of encouraging exports within a break-even financial constraint. Since this could be crucial to ECGD's future performance, you may think it sensible for a report to be made on progress in developing the portfolio management approach in, say, 6 to 9 months' time.

Response to the Management Review Recommendations

11. The Management Review was conducted by a mixed team of management consultants (from Cooper Lybrand) and officials from ECGD, MPO and the Treasury. It recommended that a Board of external, part-time Executive Directors, under an outside Chairman, should be appointed to run the Department, and that the present Advisory Council - a statutory body set up to advise on ECGD's commercial business - be abolished. It recommended radical changes in ECGD's organisation and working procedures, to be implemented over 2-3 years, and increased application of information technology (IT). The changes in working methods proposed would lead to net savings of up to 500 posts. The Review also proposed changes in the grading structure, with annual increments in pay to be earned by all staff (rather than automatic) and exceptional performance rewarded by payment of more than one increment.

12. Mr Tebbit intends:

(a) to reject the Review's recommendation for a Board of external, part-time Executive Directors. He doubts whether this would be practicable and instead proposes filling two of the Under-Secretary posts by private sector ~~recruitments~~;

(b) not to abolish the Advisory Council now but to amend the statute when an appropriate opportunity arises;

(c) to implement the proposed changes in working methods and information technology, but over a 3-4 rather than a 2-year period;

(d) to accept the recommendations on a streamlined grading structure along with flexible pay arrangements;

(e) to encourage the development of portfolio management for handling political risk.

13. The Treasury are generally content with Mr Tebbit's approach. They may, however, question his reluctance to establish a Board of external part-time Executive Directors and his preference for filling two of the Under-Secretary posts by private sector recruitment. The issue is whether this is sufficiently radical to make a major impact on ECGD's attitudes. The Treasury are likely to agree to the flexible pay arrangements proposed, although they may propose some alternative means of achieving the same effect. You will no doubt, however, wish to leave the details of this, as also the question of whether ECGD should have a fifth Under-Secretary (there are 4 at present; the Review recommends 5), to be settled between Mr Tebbit and the Chief Secretary.

14. A point you may wish to probe is Mr Tebbit's proposal for a 3-4 rather than 2-year implementation period. Although 2 years always seemed ambitious, a 3-4 year timescale could lose some of the momentum of the Review, which ought now to be implemented as speedily as practicable if the necessary changes in ECGD's attitudes and financial and management practices are to be made. The longer the implementation period, the slower the benefits will accrue, and the further away the prospects of at least partial privatisation. On theother hand, the most sensitive aspect of the Review is the very large potential staff savings (up to 500 in total - 220 in Cardiff, 150 in Regional Offices, and 130 in London and Croydon). A 3-4 year timetable would give more time to absorb these savings, at the risk of some loss of the main impetus.*

* In his minute to you of 15 July the Secretary of State for Wales has drawn attention to the sensitivity of the possible job losses in Cardiff and the need to deal with this very carefully in any public announcement.

HANDLING

15. You will wish to invite the Secretary of State for Trade and Industry and the Chief Secretary, Treasury to present their papers. The Secretary of State for Foreign and Commonwealth Affairs may wish to comment on the foreign policy implications of what is proposed. The Secretary of State for Wales may have views on the implications for staff savings raised by the Management Review (since 220 of the 500 staff savings would occur in Cardiff).

CONCLUSIONS

15. You will wish the Sub-Committee to note:

(a) the financial position outlined in ECGD's Business Plan and its consequences for the PSBR;

(b) the action already taken to secure the profitability of new business and the need to keep the future of less profitable businesses under closer review;

(c) that developments in the source of export finance will not affect ECGD's role as guarantor;

(d) that no special arrangements will be needed for arms sales, but that the 1986 Corporate Plan will take account of the needs of that market.

17. You will wish the Sub-Committee to reach conclusions on:

(a) whether to endorse the definition of ECGD's role set out in paragraph 3 of E(A)(85) 46;

(b) whether ECGD's objective of encouraging exports should continue to be subject to the break-even financial constraint;

(c) whether ECGD should develop a system of portfolio management for handling political risk (as recommended by the Management Review) and provide in the 1986 corporate plan a range of quantified options for Ministers for the amount and distribution of risk they are prepared to accept in future;

(d) whether ECGD's interim objective should be to underwrite new business profitably, within existing market limits, subject to any agreed changes;

(e) whether to fill 2 of the ECGD Under-Secretary posts from the private sector or to accept the Management Review's recommendation for a part-time Executive Board; or some other solution;

(f) whether ECGD should press ahead with the changes in organisation and working methods recommended in the Management Review and on what timescale;

(g) whether to adopt flexible pay arrangements for ECGD, if necessary as a controlled experiment, subject to agreement on the details between the Secretary of State for Trade and Industry and the Chief Secretary.

18. You will also want to confirm the arrangements for announcing the Government's decisions. These are eagerly awaited in the City and Mr Tebbit will presumably wish to make an announcement to the House before the summer recess.

J B UNWIN
Cabinet Office
16 July 1985