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JU802
Secretary of State for Trade and Industry

21 March 1986

CONFIDENTIAL

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister ?
Agree to ask to be kept closely in touch with the performance of ECGD?
DRN 26/3.

Dear David,

Thank you for your letter of 10 March about ECGD's cash deficits and the Management Review.

The cash deficits result almost entirely from the substantial level of claims being paid by ECGD to exporters whose payments from countries which have had to seek more time to pay their trade debts are in arrears. The arrears relate to business undertaken some years ago. The sums involved are substantial, and forecasting ECGD's cash flow is just as hazardous as forecasting the future course of the international debt problem as a whole. When Ministers collectively looked at ECGD's finances last July, three possibilities were considered - a "base case" envisaging a cumulative deficit rising to about £2bn, a 'pessimistic case' involving a deficit rising to £4bn, and a "crisis case" carrying the deficit to £6bn or more. In the course of the past year ECGD's cash requirement has been entirely consistent with last year's "base case" assumptions. However, in his recent appearance before the Commmittee of Public Accounts, Mr Gill indicated in effect that the future might prove closer to last year's pessimistic case. This is because of the higher amount of debt relief which we now envisage will be required by a number of major debtors, some of whom have been hard hit by the recent fall in oil prices. The main countries concerned are Nigeria, Mexico, Brazil and, in the fairly near future, Egypt. Despite the higher level of debt relief which will be needed, ECGD's cash deficit could probably still be contained within a figure of £2bn, if relief were provided through refinancing loans which would enable debts to be paid on time with ECGD carrying the risk of default on the new loan. We have resorted to refinancing in a few cases so far where we were satisfied that the new loans would be paid on time. However, the four large debtors I have mentioned are to some extent at odds with the IMF. Unless these differences with the Fund can be reconciled, it may not be appropriate to refinance, in which case ECGD would pay claims to exporters and banks and wait for the money to be paid by the debtors in due course. Whether the Department's borrowing requirement will ultimately be closer to £2bn or £3bn is thus subject to a very wide range of uncertainty but, on prudential financial grounds, it would be wise to assume a figure close to £3bn by the end of the decade.

I must stress that this cash deficit is not a "loss" and will not be so unless and until the international debtors renege on their obligations. No one has yet reneged on these debts and there are strong pressures within the international financial system to ensure that debtor countries have every incentive to meet their proper obligations. The question is how long they will need in order to clear their debts and the rate of interest we receive on the debts while we wait. In their trading accounts, ECGD are setting aside increasing provisions against the possibility of an ultimate default, and the underlying trading accounts themselves have recently turned round from deficit to surplus. In other words, we have good reason to suppose that current business being underwritten on current terms and premium rates will pay its way, largely as a result of the defensive action the Department has taken in recent years for example through increased premium rates, tighter underwriting, a more rigorous approach to risk assessment, and a searching examination of loss making facilities. Indeed, many exporters are now concerned that the emphasis on ECGD's break even financial objective may be operating to the detriment of the statutory purpose to encourage trade. One symptom of this is the increasing number of controversial cases on which decisions about ECGD cover need to be taken at Ministerial level.

The Management Review is not directly related to the financial situation, though the emphasis in the review of business planning will have a very important part to play in judging the right balance between the financial duty and the statutory purpose of the Department. The review will also have a more important and significant effect on the Department's general operational efficiency underpinned by an appropriate use of information technology. The Department is now actively engaged in a wide ranging programme for implementing the review. Changes at Under Secretary level, including the recruitment on contract, after open competition, of an individual from the private sector to head up the Management Services Group, mean that the right people are now in the right places at Under Secretary level to give the appropriate impetus to the implementation of the review. Useful progress has already been made both on the business planning side and at the operational levels. The Secretary of State and the Minister for Trade will be monitoring progress to ensure that the necessary momentum is maintained.

In summary:

i ECGD's cash position will be dominated for some years ahead by the continuing repercussions on past business of the world debt problem. The amounts are substantial and forecasting is subject to very wide margins of uncertainty.

ii Tighter underwriting and risk management has turned round the underlying trading position.

iii ECGD's present management team has made a good start in implementing the management review. Progress will be carefully monitored.

I am copying this letter to Paul Pegler (Chief Secretary's office).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

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Secretary of State for Trade and Industry

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21 March 1986

David Norgrove Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Dear David,

As a tail-piece to my letter of today's date about ECGD finances and the Management Review, I ought to add that, having recruited an Under Secretary equivalent from the private sector, we are now close to the point where the present head of ECGD can bow out with the minimum of disruption, and it is our present intention to open up the post to competition from the private sector within the next two or three months.

I am copying this letter to Paul Pegler (Chief Secretary's Office).

Yours ever,

Michael

MICHAEL GILBERTSON
Private Secretary

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10 DOWNING STREET

From the Private Secretary 27 March 1986

E.C.G.D.

The Prime Minister was grateful for the account of ECGD's position set out in your letter of 21 March.

DRN agrees - no longer need to chase
MA 17/4/86

The Prime Minister would be glad to be kept closely in touch with the performance of ECGD.

I am copying this letter to Paul Pegler (Chief Secretary's Office).

DAVID NORGROVE

Michael Gilbertson, Esq.,
Department of Trade and Industry

NBM

MR NORGROVE 24 March 1986

ECGD

The letter from DTI of 21 March is unsatisfactory. It suggests that a "cash deficit is not a loss and will not be so unless and until the international debtors renege on their obligations ...". Unfortunately the cash deficit has to be charged against the PSBR but apparently we need not recognise a loss provided countries such as Poland, Brazil or Nigeria go on making the right noises for another century or so. If they do not meet their interest charges or 'roll them up', this is just a further cash deficit to be charged against PSBR, not a loss.

This may be 'water under the bridge' but it is perhaps illustrative of the attitude which enabled such huge commitments to be built up. It makes the case for strengthening the management of ECGD even more pressing, so that risk may be better measured and danger signals recognised more promptly.

If the Bank of England were the supervisory authority for ECGD, they would not be content with the above accounting policies. Should the Treasury or the Bank be asked to look at them with a critical eye?

David Hobson

DAVID HOBSON

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NW

MR NORGROVE

21 March 1986

Prime Minister

Agree that you would like to be kept closely in touch with the financial position of ECGD?

DRN 26/3.

ECGD EXPOSURE

The Bank report on the International Financial Scene dated 14 March has a table attached headed "Indebtedness and British Exposure" which shows ECGD exposure in certain listed countries at a total of \$18.5bn (say, £12.5bn) at 31 December 1985, defined as "guaranteed principal and contractual interest plus political claims paid and claims under examination".

The largest exposures enumerated therein are:

	\$bn
Brazil	1.8
Mexico	1.3
Indonesia	1.6
Poland	1.3
Romania	0.8
Yugoslavia	1.0
Egypt	0.9
Nigeria	3.2
South Africa	2.7
	\$14.6bn (say £10bn)

Even if one accepts South Africa as a good risk, the possibility of the cost to the PSBR exceeding the expected £3bn by the end of the decade cannot be dismissed,

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particularly if Egypt and any other "oil economies" prove unable to meet their liabilities as and when they fall due.

There are no grounds for complacency, and the situation will need watching with care.

David Hobson

DAVID HOBSON