

MINUTES OF MEETING HELD 17 MARCH 2004

Present: Ms Liz Airey (Chairman)
Professor Jonathan Kydd
Mr Martin Roberts
Mr John Elkington
Mr Tony Shepherd

In Attendance: Mr Vivian Brown
Mr Victor Lunn-Rockliffe
Mr John Weiss
Mr John Ormerod
Mr John Cross
Mr Peter Rossington
Mr David Allwood
Mr Paul Hillman
Mr Paul Roe
Ms Rebecca Cox

Mr Gareth Waterhouse (Secretary)

1 APOLOGIES FOR ABSENCE

Apologies were received from Sir Stephen Brown, Mr Armitt, Professor Kate Phylaktis, and Dr Thamotheram.

2 MINUTES OF THE PREVIOUS MEETING

The minutes of the meeting held on 21 January 2004 were approved and signed.

Matters Arising

2.1 Departure of Vivian Brown and new Chief Executive

2.1.1 The Chairman gave Mr Brown the Council's best wishes and thanked him for his close involvement with its work.

2.1.2 Mr Brown said that he had enjoyed working with EGAC during a particularly difficult and interesting period.

2.1.3 Mr Brown hoped to announce his successor before he departed, but it was unclear whether this would be possible. John Weiss would take over as interim Accounting Officer for the period before the new Chief Executive arrived, which was anticipated could be up to three months.

2.2 Heads of Agreement and Trading Fund

2.2.1 Mr Brown said that the Secretary of State hoped to secure some improvement in the terms of Heads of Agreement 3 (HOA3). She had written to the Chief Secretary to the Treasury, and a meeting was scheduled. She hoped to address to some degree the strong expectation from customers that ECGD should be more competitive with other ECAs, possibly by altering the financial targets. The Secretary of State also wanted continuity for some form of FREF product, and assurances regarding the ongoing voted payment and the terms of burden sharing that were yet to be agreed.

2.2.2 It was impossible to launch the Pilot in July. The Roadmap Programme, the Department's project to update major IT systems and processes, was scheduled for implementation in October and would consume a large amount of staff resource in the preceding months. A clash was thus not feasible, so the earliest date for introduction of the Pilot was January 2005. Once Ministerial agreement was reached, a more detailed timetable would be

finalised. It was envisaged that the Pilot would be run for at least eighteen months, so there had been no view on timing for a Statutory Fund.

2.3 EGAC Meeting with HMT

2.3.1 The Chairman said that the meeting with Treasury had been very interesting. They had urged the Council to push DTI Ministers as HMT were ready to agree HOA3. One Council member said that HMT appeared keen to step back and allow ECGD to operate as an independent unit behaving on a commercial basis.

2.3.2 Mr Brown said that ECGD would be operating within a set framework. ECGD would thus be constrained but not subject to direct HMT control. However, independent and commercial behaviour might prove more elusive if ECGD became subject to more control from DTI, and this was a potential problem. The exact arrangements and results were still to be worked out, but the Strategy Forum would be important for setting clear direction.

2.3.3 One Council member said that it was clear that ECGD was the only European ECA that was not run for the benefit of exporters. The emphasis was on avoiding loss rather than supporting business. Mr Brown said that HMT had clearly stated that a major reason for ECGD's existence was that unilateral removal would clearly disadvantage British exporters in comparison to foreign competitors.

2.3.4 One outcome of the meeting was a closer relationship between the Council and HMT. It was agreed that HMT would be asked to make a presentation to the Council on ECGD's International Strategy at some point in the future. It

was also agreed that HMT would send an observer to future Council meetings to continue working more closely together.

2.3.5 A major item at the meeting was discussion of HMT supporting ECGD in the International Strategy to achieve a level playing field with other ECAs. Treasury had said that they were committed to making progress. Mr Brown said that HMT had limited resources, but their constructive involvement was important to help reform the system. Mr Ormerod said that they would add more value as they gained experience and were able to commit more time to international negotiations.

2.3.6 One Council member said that he had previously attended a meeting between CBI and HMT. His experience at the EGAC meeting was much more positive, and he hoped that it showed a change in Treasury attitude.

2.4 Bribery and Corruption

2.4.1 Mr Ormerod said that there had been no formal reply from the Minister to the Council's letter after the last meeting. Mr Weiss said that the overall bribery and corruption agenda had moved on, but the specific issue of ECGD having investigative powers had been put on hold, pending further research. Mr Ormerod said that meetings had taken place with NCIS and the Minister was content that ECGD was fitting into the overall anti-corruption process. New procedures were being introduced at ECGD from 1 May.

2.4.2 The Chairman said that the changes to NCIS had been announced very soon after the meeting. Matters appeared to be proceeding in line with Council advice, but an update was requested for later in the year.

3 ACTIVE PORTFOLIO MANAGEMENT – EGAC(04)06

3.1 Mr Lunn-Rockliffe introduced the topic, making the following main points:

3.1.1 The Council had asked for a general update on APM, and details of experience with the Credit Derivatives programme.

3.1.2 A review had recently been completed, subsequent to the appointment of John Cross as the new Director for PMD. The plan was to continue the programme, although continuing uncertainty over the financial framework meant that assessing value for money was more difficult.

3.2 Mr Cross presented the paper, making the following main points:

3.2.1 The APM programme, along with a large amount of other work, had originated with the Mission and Status Review and KPMG report.

3.2.2 Portfolio management had become a feature of the financial industries in the last ten years for a number of reasons, for example: better quantitative modelling; the need for insurers and banks to rebalance their portfolios; greater liquidity in the markets; and advances in securitisation. Firms had endeavoured to improve their risk return profiles, and there had been clear evidence that high unexpected credit losses led to significant underperformance in the share prices of financial companies.

3.2.3 To date, banks had focussed most of their APM efforts on investment grade risks, where there was liquidity in the market. ECGD faced a far greater challenge in attempting to offload emerging market risk where there was extremely limited market liquidity.

- 3.2.4 The risks in the portfolio were of three varieties: credit risk, concentration risk and correlation risk. APM hoped to reduce significantly the year to year volatility of ECGD's financial performance by managing concentration and correlation risks downward.
- 3.2.5 Risk transfer would only take place if assessed as value for money (VFM). One current issue was that, in the absence of an agreed capital framework, there were only limited opportunities where VFM was certain (ie those highly concentrated markets).
- 3.2.6 The APM programme was also helping to develop the private sector market, which was an important strategic goal.
- 3.2.7 The recent workshop on APM strategy had considered potential approaches. Major transactions, using reinsurance or securitisation, were complex. There was a need to convince market counterparties for such operations of ECGD's systems and track record. Although large amounts of risk could be offloaded, the process took a long time.
- 3.2.8 ECGD had thus taken a more flexible and focussed approach in the last few months. A small number of transactions in the Credit Default Swaps (CDS) market, which was well established, had been used where prices were advantageous. It had taken a while to put processes in place, but it was now possible to dip in and out of the market. There were some problems, however: the products were not perfectly tailored to ECGD risks, so there was some residual (basis) risk; and it would not be possible to use it for all markets where ECGD had exposure. CDS was a useful place to begin activity, but would not be able to meet all of the aims for the programme.

3.2.9 The resolution of HOA3 was important for the future of the programme, but work on CDS was continuing in the interim where appropriate. An important conclusion to emerge from discussions was that it was necessary to look at the future of the portfolio. Run-off had meant that China was no longer as big a concentration issue as when APM investigations began, and the portfolio was likely to become increasingly concentrated with airlines business. Ways to deal with this problem going forward were being investigated.

3.3 In discussion, the following points were made:

3.3.1 One Council member said that it was an oddity that a government, which could easily absorb risks, chose to pay the private sector to take them away. Costs were being incurred due to choices about the management of departmental relationships. Mr Lunn-Rockliffe said that there was a clear and agreed policy that ECGD risks were not considered to be diversified across government.

3.3.2 A Council member agreed that using CDSs, rather than relying on reinsurance, was appropriate given the performance and behaviour of the respective markets.

3.3.3 The programme was designed to reduce both concentrations and the costs of actual losses. It was not possible to diversify the portfolio by managing upwards – i.e. purchasing exposure where current concentrations were low. Mr Brown said that a portfolio approach meant that there was a greater readiness to take on business in markets where exposure was low. Mr Rossington said, given the nature of ECGD's business, that there was no way in which sufficient diversity of risks could be achieved to attain the levels

of capital efficiency achievable in the private commercial markets. It was also important to emphasise that the activity was part of a portfolio approach with a focus on portfolio concentration risk rather than credit risk – certain foreign governments had wanted reassurance that selling off risk was not a slight on their creditworthiness from the UK Government.

3.3.4 One Council member said that the Basle Accord had encouraged banks to offload good risks to improve capital adequacy. He asked if the Treasury constraints would have the same effect. Mr Cross agreed that rigidity and features of regulation did generally have an impact on portfolio policies. Care would need to be taken in this regard with respect to the terms of HOA3. Mr Brown said that this had been considered in negotiations. Setting the rate of return had a direct impact on incentives for APM. A higher rate of return, and hence a larger voted payment, would provide extra incentives and resources for offloading risk.

3.4 The Council were grateful for the progress report, but provided no specific advice.

4 REVIEW OF ECGD'S SHORT-TERM REINSURANCE ARRANGEMENTS – EGAC(04)05

4.1 Mr Ormerod presented the paper, making the following main points:

4.1.1 When ECGD's short-term operations had been privatised, an ECGD short-term reinsurance facility was established in order to ease the transition. After initial interest in this facility, no new reinsurance business had been required since 1998/99.

- 4.1.2 Following the Mission and Status Review in 2000, the facility was moved to a standby basis only for activation in a “reinsurer of last resort” role. At that time, it was also decided that a review would be conducted at the end of 2003.
- 4.1.3 It was now being proposed that the standby facility should be withdrawn. It had been created as an interim measure, not part of core business, and the private sector market had shown that there was no market failure. An alternative proposition was also being offered – insurers could pay a commitment fee to keep the facility available.
- 4.1.4 ECGD was required to hold a consultation on this issue. This would accord with government guidelines, and be open for twelve weeks, but the consultation paper would not be sent to all stakeholders. Letters would go to the three insurers that had used the service in the past and also trade associations.
- 4.1.5 The Council were asked for any advice on the form, nature and content of the consultation. EGAC views on the actual proposal could be taken into account at a later time.
- 4.2 In discussion, the following points were made:
- 4.2.1 One Council member said that he had been consulted on this issue at an earlier stage, and fully supported what was proposed. He felt that the cost of holding the facility should be emphasised, as insurers should have to pay for the availability of the service.
- 4.2.2 Another Council member said that the matter should be investigated further. Private insurers were not offering the same products as ECGD had been in

1991. An example was the inability to obtain cover to support work in progress. Mr Brown said that exporters had not raised this as a problem during the Mission and Status Review. The fact that reinsurance had been available had not affected this situation, so withdrawing it should have no impact.

4.2.3 Mr Weiss said that he was concerned that there would be an obligation to take on risks if an insurer offered to pay for the continued existence of this service. Mr Ormerod said that this provision was added to avoid responses that desired a continuation of the current arrangement where there was no cost to ECGD or insurers. The need to allocate capital to a standby facility under a Trading Fund would change this situation, and the remit of the consultation would not commit ECGD to a certain course of action.

4.3 The Council approved of the proposals for the consultation. Any specific comments could be made in response to it during the consultation period. The Council were interested to see the responses and comments that were received.

5 CASE REVIEW: BTC PIPELINE

5.1 The Chairman declared a conflict of interest. She held a non-executive position at AMEC, a contractor involved in the project.

5.2 Mr Allwood gave a PowerPoint presentation, making the following main points:

- 5.2.1 The analysis of the project was in far more detail than could be presented in the meeting, and Council members were invited to view the full Underwriting Committee report if they wished.
- 5.2.2 Despite the UK involvement in the project being relatively small, ECGD had been heavily involved in the business principles aspects and had greater influence than the financial commitment merited.
- 5.2.3 BP had been determined to implement the best pipeline project that had been constructed. The construction had been run as three separate projects in each of the countries, with BP providing overarching control.
- 5.2.4 Politics had dictated the route – the aim was to get the oil from the Caspian to the Mediterranean without going through the Black Sea, Iran, Armenia and certain areas of Georgia. A 10km wide corridor was identified, and this had then been narrowed to 100m. The actual pipe was 48 inches in diameter, narrowing to 42 for the downhill section in Turkey.
- 5.2.5 Mott McDonald had been appointed as advisers, but a number of consultants had been involved on behalf of the individual agencies providing finance. ECGD had not joined the initial review, as there was no guarantee of British involvement. The review process had taken over a year, and included visits to the pipeline route. After financial close, the lenders had appointed d'Appolonia to carry out regular monitoring visits.
- 5.2.6 A wide range of stakeholders, including pressure groups, were involved throughout the process. Some groups were fundamentally against the project, others gave input in the hope of improving it and there were some who saw it as very positive. Some NGOs saw this as a high profile

opportunity to put pressure on BP. Regular meetings had been held, and there had been a large amount of correspondence, in addition to numerous Parliamentary Questions.

5.2.7 A large number of documents had been produced, including eleven thousand pages of reports that had been put in the public domain.

5.2.8 Every effort had been made to ensure leaks were prevented or spills minimised. Sensors ran along the whole route, and patrols monitored from above ground.

5.2.9 ECA involvement had helped gain a number of improvements. These included enhancing rights where land had been expropriated, increasing transparency, and engagement in establishing the rules governing security forces. The Environmental and Social Action Plan (ESAP) had been improved in a number of ways, including a commitment by BTC to comply with evolving international standards.

5.2.10 Overall, the BPU considered that the project complied with all relevant guidelines and standards. All pre-conditions to disbursement had now been met, and the first loan drawdown was scheduled.

5.3 In discussion, the following points were made:

5.3.1 One Council member asked about reports regarding problems with the pipeline coating. Mr Allwood said each weld was coated to prevent external corrosion. During routine inspection, it was noticed that hairline cracks had appeared on some joint coatings. It emerged from the subsequent investigation that it had been too cold while the coating cured, and a revised procedure was arranged to address this problem. Although joint coating and

pipeline burying had been held up slightly, there was confidence that no badly coated joints were buried. This incident was not expected to have a significant financial impact on the project or delay the overall implementation schedule.

5.3.2 With reference to security for the pipeline, Mr Allwood said that BTC had no armed guards. Horseback and four-wheel-drive patrols monitored the length of the pipeline. Efforts had been made to ensure that locals received benefits from the pipeline along the route, and thus had an incentive to protect it. The host governments had committed to providing security and one of the current activities was agreeing the rules of engagement for these forces. Improvements had been made to the oil spill response plan in case a terrorist attack did cause a leak from the pipeline.

5.3.3 Mr Allwood said that he believed the ECA group worked very effectively, making reasonable requests that were all accepted by the project sponsors.

5.3.4 Ms Cox said that it appeared up to six UK exporters could be involved. It was possible some smaller companies would also gain contracts.

5.3.5 One Council member asked about the benefits of the pipeline to communities and the host countries. Mr Allwood said that the central government in each country received fees from the transit – these amounts were to be made public, and it was hoped the governments would direct funds to the more needy parts of the countries. The project had also spent \$25m in assistance to local communities.

5.3.6 There were limited wildlife interests in this project. The BTC project would actually repair some damage from older pipeline construction, and the route had been altered around archaeological finds.

5.3.7 Mr Brown said that the project showed real progress in the practices of other ECAs, as it was clear that they were applying the agreed standards and moving towards ECGD's position. Mr Allwood said that BP and BTC also learned from the project, including dealing with adverse publicity and engaging with stakeholders.

6 GUARANTEES ISSUED – EGAC(04)07

6.1 Mr Allwood gave some brief details on the experience with the revised case impact analysis process. 80 cases had been received during the year, 55 of which were rated as low potential impact, 14 medium and 11 high. For the 55 low impact cases, the new procedure had significantly reduced the administrative burden, while avoiding the risk of failing to identify any problems. More detail would be contained in the BPU six-monthly report.

7 ANY OTHER BUSINESS

7.1 Meetings with Stakeholders

7.1.1 It was agreed that arrangements should be made for the Council to meet officials from DTI before the next meeting.

7.2 Items for next meeting

7.2.1 In addition to discussion of the International Comparisons Report, the Council hoped that officials from HMT could attend the meeting to present the agreed International Strategy.

GARETH WATERHOUSE

EGAC Secretariat