



THE ESTABLISHMENT OF A TRADING FUND

PUBLIC CONSULTATION DOCUMENT

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SECRETARY OF STATE'S FOREWORD

In July last year my predecessor, Stephen Byers, published the Review of ECGD's Mission and Status. This recommended a far-reaching programme of reform for ECGD. The programme embraced all aspects of the organisation: the principles by which it should manage itself, its relationships with its stakeholders, and how it could better serve its customers, UK exporters. The Government accepted the recommendations of the Review. Much has since been done to implement them.

One of the major reforms was to introduce modern risk management systems. These should focus upon both transaction risks – individual deals – and the portfolio as a whole. The key change was to introduce a capitalisation framework for managing exposure. This was seen as vital for the closer integration between more effective portfolio management and ECGD's approach to handling individual transactions.

We introduced a shadow-capitalised framework in April this year, and it has now been in operation for some 4-5 months – the key elements and experience to date are set out in this paper. We now need to focus on the next step of the process – to convert shadow capitalisation into a real framework by setting up a Trading Fund for ECGD's operations from April 2002. The purpose of this paper is to consult stakeholders, and in particular ECGD's customers, about how we should address this task. I very much hope that they will respond and let us have their comments and views.

ECGD's Trading Fund will be by far the largest yet established – in fact its asset base will be larger than all other Trading Funds put together. It will bring with it far reaching changes in ECGD's culture and approach to risk management. A real capital framework will enable the Treasury to grant ECGD wider operational autonomy with the confidence that risks are being properly assessed, controlled and managed. Robust risk management is in the interests of ECGD's customers; a financially strong and operationally autonomous ECGD will be far better placed to support UK exporters and investors overseas, and hence bring economic benefits to the UK. I hope also that by setting up a Trading Fund, we will be able to facilitate a closer partnership between ECGD and the private sector financial markets through more active risk transfer arrangements.

I look forward to seeing the views expressed as part of this consultation; they will form an important input into my decision on the setting up of the Trading Fund as announced by Ministers following the Mission and Status Review.

Patricia Hewitt
Secretary of State for Trade & Industry

1 INTRODUCTION

- 1.1 This paper sets out, for consultation, proposals for the establishment of a Trading Fund, under the Government Trading Funds Act 1973, in respect of ECGD's operations.
- 1.2 The proposals stem from the recommendations of the Mission and Status Review of ECGD. This was presented to Parliament in July 2000 (command paper Cm 4790, which can be obtained from ECGD's website at www.ecgd.gov.uk). The Review concluded that ECGD should strengthen its risk management systems by introducing a capitalised framework, informed by best commercial practice; and that this could best be achieved by establishing a Trading Fund for ECGD's operations.
- 1.3 The Review also concluded that capitalisation should proceed in two stages:
 - a "shadow" framework, encompassing the key elements of capitalisation should be introduced by April 2001; and
 - a Trading Fund to commence operations in April 2002, drawing on the experience of operating under the shadow framework.
- 1.4 The recommendations of the Review were accepted by Ministers and announced to Parliament.
- 1.5 The shadow framework was introduced on schedule and has now been operating for some 4 - 5 months. The key elements, and experience to date, are described in Sections 2 and 3 of the paper.
- 1.6 The Secretary of State will decide later this year on the second stage of capitalisation, namely, the establishment of the Trading Fund. This will be informed by the results of the consultation on the proposals for a Trading Fund set out in this paper. The results will be laid before Parliament in advance of a Statutory Instrument being tabled.
- 1.7 This consultation conforms to the Cabinet Office code of practice on written consultation (the main criteria of which are reproduced at Annex 7) with the exception of the period allowed for responses. This is explained at paragraph 6.1, below.

2 BACKGROUND TO CAPITALISATION

2.1 The Risk Management Review

The conclusions of the Mission and Status Review were based, in part, on an independent assessment, made by KPMG, of the adequacy of ECGD's political and country risk management systems and ethos, and the Treasury's role in the process. The KPMG Review was published in parallel with the Mission and Status Review, together with ECGD's Action Plan, and can be obtained from ECGD's website (www.ecgd.gov.uk).

2.2 KPMG's Key Conclusions

- 2.2.1 ECGD's approach to risk management was based on sound principles. However, ECGD needed to move from a transaction to a portfolio approach to reflect aggregate risks more appropriately.
- 2.2.2 The process for making risk decisions should be streamlined, with the emphasis and resources to be focused more effectively on a portfolio approach and proactive risk appetite setting. KPMG, whilst acknowledging the constraints on ECGD's role, particularly recommended that ECGD should do more to pursue a pro-active risk management strategy.
- 2.2.3 KPMG gave strong support to the work then being done by ECGD to develop a capitalised framework for risk management. Such a framework, based on capital adequacy and solvency principles applicable to banks and insurance companies, could be used to link decisions on individual transactions directly to portfolio targets and constraints. This would provide a more transparent and integrated approach to risk appetite, exposure concentration, and premium and cover policies. KPMG emphasised, however, that the introduction of capitalisation would require a fundamental change to ECGD's business strategy and operating framework.
- 2.2.4 KPMG also recommended that these changes should enable the Treasury to adopt a more strategic role in their oversight of ECGD, with ECGD having greater autonomy and clearer accountability to manage its business within the capital framework and its financial performance targets.

2.3 Ministers' Conclusions

- 2.3.1 Ministers agreed that ECGD should introduce a capitalised framework along the lines recommended by KPMG. In doing so, however, Ministers agreed that there should be no change in ECGD's overall risk-reward balance.
- 2.3.2 This meant that:
 - A there should be no change in ECGD's risk-reward appetite, and ECGD's capital should be structured to enable it to support the same broad volumes of business over time as it has in the past;
 - B ECGD's financial objective to break even should remain the same; and
 - C ECGD should have a challenging target for remunerating its capital, while setting appropriate premium rates based on sound risk assessment. A voted payment will be made to the Trading Fund which should, taking one year with another, allow it to meet the target for return on capital without affecting the risk reward balance.

2.3.3 Ministers also strongly endorsed the recommendation that ECGD should be given greater operational autonomy once it had satisfactorily introduced the capital framework and addressed the other recommendations made by KPMG for improving its risk management systems. KPMG have carried out a follow up study to review progress, and a further review is planned during the autumn, after which they will make a recommendation to the Treasury on whether it should grant operational autonomy to ECGD, with the Treasury moving to a role of more strategic oversight.

3 THE SHADOW CAPITALISED FRAMEWORK

3.1 Introduction

The shadow-capitalised framework was introduced as planned on 1 April 2001. The key elements of the framework are set out below.

3.2 Vested Operations

3.2.1 Almost all of ECGD's current operations have been incorporated into the framework, and the intention is to vest these same operations in the Trading Fund. Two of the exclusions are:

- A the assets on Account 1 (see Annex 5 for a note of ECGD's accounting arrangements) represented by debts owed by Highly Indebted Poor Countries (HIPCs), which are targeted for 100% forgiveness; and
- B Account 3 – comprising of business which does not meet ECGD's normal underwriting criteria, and which has been taken under instruction from Ministers. Account 3 (both existing exposure and any future business) has been excluded as it does not represent part of ECGD's normal trading activity.

3.2.2 Most of the vested operations comprise ECGD's "new business" account – Account 2. At 31 March 2001 contingent liabilities in respect of Account 2 stood at £18,242 million. Account 1 – the "pre 1991 business" account – is running down as liabilities expire; at 31 March 2001, total contingent liabilities in respect of Account 1 stood at £785 million.

3.2.3 The main focus of capitalisation is clearly on Account 2. However, inclusion of Account 1 'performing' assets has significant advantages in that ECGD will be able to manage its portfolio in a more integrated way, particularly in respect of countries where it has exposure in both Accounts.

3.2.4 Account 4, which represents ECGD's interest rate support and hedging operations, has also been vested. This will allow ECGD to consider capital allocation and pricing for its guarantee and interest rate products in a more integrated way, with consequential potential benefits for customers.

3.3 Capital: amounts and structure

3.3.1 Strategy

The capital structure is intended to maintain the risk-reward balance as described above, and to provide ECGD with clear incentives for the effective management and control of risk. ECGD has calculated its capital using a portfolio risk model based on a standard commercial template – J P Morgan's Creditmetrics. The template has been adapted so that it can be used in emerging markets, which account for most of ECGD's business. The important assumptions in calculating capital, apart from the risk model, are the projections for future business volumes and the global risk environment – whilst Expected Loss, plus the margin agreed by Ministers to provide greater confidence of break-even, will continue to be covered by premium income, capital will cover Unexpected Loss. The intention is to provide sufficient capital to enable ECGD to support the same broad volumes of business through the economic cycle.

3.3.2 Exchequer Guarantee

Notwithstanding the capital structure, the establishment of the Trading Fund will not restrict the access of the Secretary of State to government funds where required to meet ECGD's liabilities. ECGD's credit rating will therefore be that of the UK Government and, accordingly, its guarantees will continue to attract zero capital weighting for banking regulatory purposes.

3.3.3 The key elements

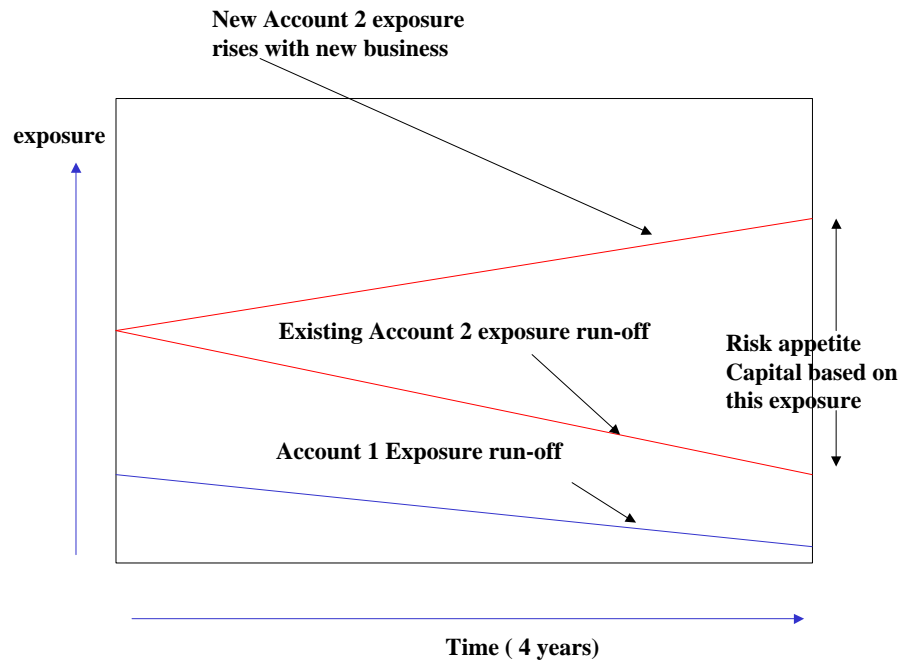
A Base Capital (incorporating Risk Appetite Capital)

The main component of capital is the Risk Appetite Capital (RAC). RAC is intended to support the existing Account 2 exposure and future business; as risk expires on the existing portfolio, the RAC released can be recycled to support new business. RAC has been set to take account of ECGD's business projections for the next four years; these envisage growth in the Account 2 portfolio, and consequently RAC has incorporated into it an element to reflect this growth. Capital has been based upon the risk environment at 1 April 2001.

Capital will also be needed to support the Account 1 portfolio to be vested in the capitalised framework. But this capital will not be recycled as risk runs off: it will be returned to the Exchequer. This capital requirement is also calculated to reflect the risk environment at 1 April 2001.

The sum of RAC and the capital needed to support Account 1 exposure is called the Base Capital.

The exposure equivalent of this capital structure is shown below.



NB this is shown in exposure terms; capital is broadly equivalent. Diagram is not to scale.

B Risk Volatility Capital

ECGD's risk will continue to be vulnerable to changes in the global economic environment, and it is therefore important that ECGD should have adequate capital through the economic cycle. If ECGD did not have adequate capital, a deterioration in the economic environment would crowd out headroom for supporting new business. In addition, therefore, to Base Capital, ECGD will be given "Risk Volatility Capital" (RVC). ECGD will be able to access RVC whenever there is an adverse change in risk (including foreign exchange risk) relative to the risk assessment used to assess the base capital requirement (including Account 1 capital). Drawings on RVC will be added to Base Capital. RVC is intended to be a stabilising mechanism, in that if the risk environment improves relative to the base case, capital will move from Base Capital to RVC.

RVC and Base Capital together comprise Credit Insurance Capital, which will be remunerated.

C Supplementary Capital

RVC is intended to provide sufficient capital for ECGD's business through an economic cycle. However, ECGD will also be able to call upon capital held off the balance sheet – Supplementary Capital – in times of very severe economic crisis, provided that it has adhered to sound risk management policies as set out in its risk and corporate governance policies. Supplementary capital has been set at 150% of RVC. Supplementary Capital will be remunerated only if it is drawn.

D Export Finance Capital

ECGD's policy, in relation to its interest rate support schemes, will be to hedge risk as much as is practical to do so, and subsequently to refinance the related guaranteed loans. This will reduce uncertainty and the corresponding need for capital. Some capital, however, will be needed to cover the residual unhedged risks. This capital will be returned to the Exchequer as the risks expire. Additional capital will be used to support future interest rate activities (which are also based on ECGD's business projections), and this capital can be recycled as risks expire to support more interest rate support activity. The total capital for interest rate support schemes is called Export Finance Capital, which will be remunerated.

3.4 Projected Capital Values

The capital amounts have yet to be finalised, but the current estimates are summarised below:

Element of Capital	£ billion
Base Capital (of which Risk Appetite Capital = £1.59bn)	1.933
Risk Volatility Capital	0.621
<u>Total Credit Insurance Capital</u>	2.554
Export Finance Capital	0.300
<u>Total Balance Sheet Capital</u>	2.854
Supplementary Capital	0.932
<i>[NB These are the capital amounts for 1 April 2002. Capital will vary as exposure runs off].</i>	

3.5 Remuneration of capital

3.5.1 Target

All Trading Funds are required to have a target. The government's standard return on capital employed (ROCE) target for Trading Funds operating in conditions of market failure is 8% "real". ECGD has a target ROCE for the shadow capitalised framework, and the intention is to carry this forward for the Trading Fund. ECGD's ROCE target is 6%, specified in real terms. This applies to most of the Base and Export Finance Capital (capital needed to support some non-performing Account 1 exposure will be excluded from the ROCE targets).

3.5.2 Inherent Rate of Return

ECGD's current premium rates, which are designed to meet ECGD's Reserve Coverage targets, set by Ministers (see Annex 6 for further details), should enable it to remunerate the capital (a mixture of RAC and RVC) required to support Account 2 at a rate of around 5% "real" – in other words, current premium rates will contribute significantly to the dividend requirements. Most rates are currently the same as the OECD minimum Benchmark rates. The Government's policy remains that rates should reflect risk.

Account 1 revenue flows (e.g. moratorium interest in respect of unrecovered claims) should enable the servicing of dividends in relation to the capital need to support Account 1 exposure; similar considerations apply to Export Finance Capital.

3.5.3 Voted Payment

To assist ECGD to meet its ROCE target without the need to raise the overall level of premium rates, there will be a voted payment from Parliament to cover the difference between 5% and 6% real i.e. between what can be achieved from actual current rates of return and the ROCE target. Once the Trading Fund is established the payment will be for the account of the Trading Fund. For 2001/02, it is estimated that the voted payment will be around £40 million. The voted payment will be reviewed, in April 2005, in the light of ECGD's financial performance, and, in particular, experience with Active Portfolio Management – see below.

3.6 Financial objectives

3.6.1 All Trading Funds are required to break-even by Statute.

3.6.2 Within this overall target, ECGD will continue to have the following financial targets, set by Ministers:

- A to achieve a Return on Capital Employed (ROCE) of 6% "real", as described above;

- B to maintain the ratio of cumulative reserves (Underwriting funds and surpluses) to Expected Losses on Account 2 – the Reserve Coverage Ratio (RCR) at a level of at least 1.5;
- C to maintain an in-year RCR of at least 1.4 – where RCR is defined as the ratio of premium income (net of administration costs) on Account 2 guarantees which have become effective during the financial year, to the expected losses on those guarantees based on up-to-date risk assessments and;
- D to maintain a non-negative net asset value (based upon “mark to market” valuations) on the interest rate and hedging book.

3.6.3 Performance in respect of B above will be measured by reference to an index - the ratio of the actual cumulative RCR to 1.5 (i.e. if the index is equal to or greater than 1, ECGD will have achieved its target). Account 2 will be protected from deterioration in risk in certain non-performing markets in Account 1 (conversely windfall gains will accrue to the Exchequer).

3.7 Risk management

3.7.1 Capital Adequacy

- A In lay terms, ECGD must ensure that there is a 99.1% chance that capital and reserves will be adequate to meet all losses on vested operations over a 10-year period. This represents ECGD’s capital adequacy target in relation to its Total Balance Sheet Capital (see table above). The target is broadly equivalent to a Standard & Poors AA credit rating (a separate capital adequacy target will apply to Export Finance capital to take account of the different risk profile of interest rate support activities).
- B Capital adequacy will be measured using the portfolio risk models (see paragraph 3.3.1 above). These risk models will be kept under review to ensure that ECGD keeps abreast of commercial developments in risk management.

3.7.2 Capital Allocation

- A ECGD’s capital allocation system is designed to achieve three objectives:
 - I to ensure that all new exposure taken on is backed by capital;
 - II to ensure that ECGD achieves its capital adequacy objectives; and
 - III within these constraints, to allocate and manage capital and exposure so as to optimise the achievement of ECGD’s Mission and Objectives.

- B Allocation of capital is managed centrally within ECGD, but a key service objective is to ensure that ECGD continues to meet its customer service targets of issuing all indications within 4 working days of receipt of an application for support. At present, the rate is 60%, but the intention is to increase internal delegations as soon as the next version of the risk model comes on stream in October. This should enable ECGD to once again achieve its target of 100%.

3.8 Active Portfolio Management

A major advantage of the capital framework is that it will encourage ECGD to adopt a more active approach to risk management; without the capital framework, there was no effective means to measure and price risk volatility. It is presently designing a programme of risk transfer to the private sector banking and insurance market; early indications from the market are encouraging. The strategic aim of the risk transfer programme is to facilitate active partnership between the public and private sector in the management of risk, whilst maintaining the current risk reward balance of ECGD's portfolio. If successful, the programme will enable ECGD to support its business with less capital.

3.9 Experience So Far

Experience of operating within the new framework is encouraging. Although there have been teething problems with the case handling system, these are being ironed out. On the positive side, ECGD has been able to consider and indicate on applications, which it could not have supported under the old system, and the decisions taken by ECGD are leading to speedier responses to customers. KPMG are due to carry out a follow up review next month and, subject to their recommendation, ECGD will be granted full operational autonomy within a new framework of Treasury strategic control.

4 THE TRADING FUND MODEL

4.1 A real capital framework

Ministers decided to establish a real capital framework in order to provide a more effective financial discipline along commercial lines, in accordance with the recommendations of KPMG in their Risk Management Review; this in turn would enable the Treasury to adopt an even more strategic role, with ECGD having greater operational autonomy i.e. to take decisions about risks on transactions and countries, to set prices and allocate capital in accordance with its financial targets, without the need for reference to the Treasury that now obtains. In addition, a real framework would enable more transparent reporting. It would also facilitate active risk management in providing a better focus for reducing the volatility of the portfolio. The establishment of a Trading Fund is the only way of introducing such a real capital structure into ECGD's business within the existing legislative framework.

4.2 Trading Funds Explained

A Trading Fund is essentially a financing mechanism for Government trading activities. The objective is to set up autonomous operations with their own capital base, thereby enabling more effective financial and business management along conventional commercial lines. In particular, it would not be necessary to seek funding from Parliament each year (through the Parliamentary Supply process) for operations vested in the Trading Fund. Instead, the Trading Fund's financial resources would be managed within the framework established by the Government Trading Funds Act, 1973. In basic terms, a Trading Fund may keep cash received, may borrow (only from its authorised public sector lender) and may invest surplus funds (only in the public sector), but must also pay dividends to the Exchequer.

Whilst this means that ECGD would no longer have to go through the same Parliamentary Supply process, ECGD would, of course, continue to be responsible to Parliament through Ministers.

4.3 Status

4.3.1 The status of the operations vested in the Trading Fund would not change. They would remain within central Government. Nor would there be any change to ECGD's Mission and primary objectives (outlined at Annex 3). The management of the Trading Fund would continue to be accountable to its Minister and would be subject to the same basic administrative (though not accounting) rules and procedures as operations funded through the traditional Parliamentary Supply process, although with greater authority to commit expenditure.

4.3.2 In addition, as mentioned earlier, the establishment of a Trading Fund for ECGD's operations would not restrict access, by the Secretary of State, to government funds which may be required in order to meet ECGD's liabilities. [Characteristics of the proposed Trading Fund are described at Annex 1 and a Question & Answer brief is at Annex 2].

4.4 Delivering a better service

Establishing an ECGD Trading Fund, with its clearer financial disciplines, would provide the Treasury with a more robust basis for granting ECGD operational autonomy, thus streamlining the decision-making process and enabling a faster and more flexible response to customer needs.

4.5 Increased Financial Flexibility

4.5.1 **Greater flexibility to match receipts to expenditure** would be available to ECGD than is currently possible through the Parliamentary Supply process. ECGD would be able to match premium receipts and recoveries with claims payments, rather than surrendering receipts to the Consolidated Fund. This in turn would relieve ECGD of the need to seek Parliamentary approval to incur expenditure each year, thereby allowing it to plan its finances on a more commercial basis.

4.5.2 **More efficient use of assets:** the ECGD Trading Fund will develop an Active Portfolio Management (APM) programme. The APM programme will transfer risk to the private reinsurance and financial markets, or, exchange risk with other Export Credit Agencies (ECAs), thus reducing the Trading Fund's capital consumption and the associated cost of capital.

4.5.3 **The ability to establish and maintain reserves:** the opportunity to establish reserves would help ECGD to both better manage its liquidity position and support more business by providing a more flexible means to develop the business and the programme of Active Portfolio Management (APM).

5 PROPOSED IMPLEMENTATION TIMETABLE

<u>16 November 2001</u>	Consultation Closes
<u>December 2001</u>	Secretary of State makes formal decision on the plan to establish a Trading Fund.
<u>January 2002</u>	Secretary of State lays Consultation Report, containing her conclusions, before Parliament.
<u>1 February 2002</u>	Subject to the Secretary of State's decision, Trading Fund Order laid before Parliament.
<u>February/March 2002</u>	Parliamentary approval.
<u>1 April 2002</u>	ECGD Trading Fund commences operations.

6 COMMENTS

6.1 Consultation Period

The Mission and Status Review provided a major opportunity for all of ECGD's stakeholders to set out their views on the future of ECGD. The conclusions of that review, including the proposal to set up a Trading Fund for ECGD's operations, took account of the extensive consultation. Since the Trading Fund proposals were first announced on 25 July 2000, major stakeholders have been regularly briefed, in particular at customer seminars, on the development of the capitalised regime (and Trading Fund). In view of the extent of consultation to date, 7 weeks is considered a sufficient period for this final (formal written) phase of the consultation exercise.

6.2 Responses

ECGD would therefore welcome your views on the establishment of an ECGD Trading Fund, as described above. Comments, which should be received no later than **16 November 2001** and include your name (and if you are commenting on behalf of a representative group, a summary of the people or organisations you represent), may be sent to **Tony Cattell**, Financial Structures Project Manager, as follows:

By Post:	ECGD Lambourne House Lambourne Crescent Llanishen Cardiff CF14 5GL
By Fax:	029 2068 1905
By email:	<u>tfconsultation@ecgd.gov.uk</u>
Via ECGD's Web Site	<u>www.ecgd.gov.uk</u>

6.3 Enquiries

If you wish to make your comments verbally, or have any questions about this consultation, or Trading Funds generally, please telephone **Tony Cattell** on **029 2032 8503**.

6.4 Publication

You should be aware that your response to this consultation document may be made publicly available in whole or in part at ECGD's discretion. If you do not wish all or part of your response (including your identity) to be made public, you must state in the response which parts you wish us to keep confidential. Where confidentiality is not requested, responses may be made available to any enquirer, including enquirers outside the UK, or published by any means, including on the Internet.

Annex 1: Characteristics of the proposed ECGD Trading Fund

- 1 **“Off Vote”:** At present, ECGD is funded by an annual Parliamentary Vote, a budget allocation agreed one year at a time, with any unused or surplus income returned to the Exchequer at the end of each year. The ECGD Trading Fund will take those activities vested in the Trading Fund outside this process.
- 2 **Capital:** Instead of annual Parliamentary funding, the Trading Fund will initially be funded through a capital injection (comprising of a mixture of Public Dividend and loan capital), based upon the net value of its assets (including sufficient cash to meet capital adequacy requirements) and liabilities at vesting. Thereafter, it will meet additional net expenditure and maintain capital adequacy by borrowing from its authorised public sector lender, subject to a statutory borrowing limit set so as to ensure both an element of growth in the business and the maintenance of the existing risk reward balance.
- 3 **Greater Financial Autonomy:** After its establishment, the ECGD Trading Fund will have much greater responsibility for its own finances than is currently possible, being able to retain cash received in order to meet future commitments and develop the business, whilst remaining in the public sector.
- 4 **Flexibility:** The ECGD Trading Fund will have a flexible business and financial framework that will allow for the continued improvement and development of its products for the benefit of its customers. The combination of the best practices of a public sector ethos, a culture of efficiency and a business like approach will bring benefit to Government, ECGD’s customers and the British economy as a whole.
- 5 **Breakeven:** The key financial objectives: to break even, taking one year with another and maintaining, net of administration costs, an in-year Reserve Coverage Ratio (RCR) of 1.4 and a cumulative RCR of 1.5 will remain unchanged.
- 6 **Return on Capital:** The Trading Fund will be required to achieve an average rate of return on capital employed (before interest and dividend payments) of 6 per cent, in real terms. This is not expected to result in an increase in ECGD’s premium charges, as Parliament will be asked (each year) to vote sufficient funds to the ECGD Trading Fund to cover the difference between this requirement and the existing requirement to meet the exchequers cost of funds, through the “Capital Charge” currently reported in ECGD’s Resource Accounts.

Annex 2: Your questions answered

Why the need for change?

The KPMG report on risk management recommended that ECGD should strengthen its risk management systems by introducing a capitalised framework informed by best commercial practice. As the concept of capital financing is inconsistent with the Parliamentary Supply financing arrangements used by Government departments, capital is to be introduced into an ECGD Trading Fund, which will operate outside the Parliamentary Supply arrangements.

What is a Trading Fund?

A Trading Fund is essentially a means of financing trading activities undertaken by the Government, which would have previously been financed by means of annual appropriations from Parliament (the "Supply" process).

The Trading Fund arrangements permit the establishment of a self-accounting unit, which, while remaining under the control and management of a Minister (and accountable to Parliament through that Minister), has greater freedom to manage its financial affairs. In particular, it is able to use its income to settle its liabilities and to retain any cash balances at the year-end. However, it is still subject to the same centrally applied administrative rules and procedures as a Government department.

What will change?

The main change will be the method of financing. ECGD will be financed by means of an initial capital injection (reflecting the net worth of business transferred), comprising a mixture of Public Dividend Capital and long term loans (from the National Loans Fund). Further loans may be drawn, as required, subject to the borrowing limit (agreed with the Treasury and) specified in the Parliamentary Order establishing the Trading Fund.

ECGD will no longer need to apply to Parliament each year for funds to meet commitments and authority to appropriate receipts "in-aid" of such commitments. The annual Estimates, Appropriation Accounts and Resource Accounts will no longer be required in their current form. However, high level Resource Estimates and Resource Accounts will be required in order to record the Exchequer's stake in the ECGD Trading Fund, in addition to the activities which remain outside the Trading Fund.

Furthermore, a fully capitalised regime, operated through a Trading Fund, allows more strategic oversight of ECGD's activities, e.g. through ECGD's Corporate Plan and annual (commercial style) accounts.

Trading Funds are required to break even over time and are also set financial & efficiency targets by Ministers.

Financial targets tend to take the form of a Return on Capital Employed (6% in the case of ECGD) on the Capital "invested" in the business.

After paying the dividend and interest on any borrowings from the National Loans Fund, the Trading Fund will be free to accumulate reserves, which can be used to help develop the business.

What is the parliamentary supply process?

The only cash ECGD currently has to spend is that voted each year by Parliament. ECGD is therefore unable to use cash received to meet expenditure unless authorised by Parliament and cannot use cash received in previous years to meet expenditure in the current year.

Will all of ECGD's operations to be included in the Trading Fund?

As outlined in Section 3.2 (above), some of ECGD's existing business (particularly Account 3) cannot be underwritten on commercial terms. The current proposal is to leave all assets and liabilities in respect of business written under Account 3, together with Account 1 unrecovered claims and moratorium interest owed or payable by HIPC's, outside the Trading Fund arrangements.

Is there a going concern issue?

Notwithstanding the capital structure, the establishment of the Trading Fund will not restrict the access of the Secretary of State to government funds where required to meet ECGD's liabilities. ECGD's credit rating will therefore be that of the UK Government and, accordingly, its guarantees will continue to attract zero capital weighting for banking regulatory purposes.

What legislation will be needed to enact the changes?

Under the Government Trading Funds Act 1973 (as amended), the ECGD Trading Fund may be established by the laying of a Statutory Instrument before Parliament. It is expected, subject to a final Ministerial decision, that the ECGD Trading Fund Order will be laid before Parliament early in 2002, ready for the Trading Fund to commence operation in April 2002.

Will there be pressure to cut costs?

ECGD already operates to a financial objective and is committed to increasing efficiency, not least so that it can pass on to its customers, via lower premium rates, the benefits of reduced costs. Therefore the change to the Trading Fund funding framework is unlikely to have a direct impact on ECGD's management of administration costs.

Will there be opportunities to expand ECGD's business?

Through the increased flexibility of operating as a Trading Fund, ECGD will be able to become more customer focussed, meeting the changing needs of exporters. This will at least enable ECGD to retain its current broad level of business and seek new business where opportunities arise.

What will be the Trading Fund's decision-making authority?

The Trading Fund's authority to make decisions will be set out in its Framework Document, on the basis of Statutory Consents and delegated authorities conferred by the Treasury.

Will ECGD premium rates rise as a result of Capitalisation? What about the cost of remunerating capital?

Premium rates will remain essentially unchanged. They will continue to be set so as to meet ECGD's targets, as agreed by Ministers.

Likewise, in view of the existence of a voted payment from Parliament, intended to cover the difference between the income generated by the business and our target rate of return on capital, remunerating the cost of capital should not impact adversely on ECGD's premiums overall, although in a small number of instances (e.g. certain higher risk business in already concentrated markets) rates may rise if premiums otherwise make insufficient contribution towards the cost of capital.

Will there be any changes to premium rates?

Changes to rates will continue to be determined by risk. The overall level of rates should not change; these are governed by our financial objectives, which are not changing. However, as under the present regime, there may be a handful of markets where we may need to charge more than OECD minimum benchmarks. These are likely to be high-risk markets where we have a lot of exposure. Under the previous system, we would probably have dealt with this by restricting cover. Our philosophy under the new system will be to seek to make cover available in as many markets as possible, but rather than have fixed limits on cover (i.e. Market Limits), we will use premium to balance supply and demand for cover. We think customers would prefer to have some cover available, even though the price may be higher, rather than none at all.

Will the same level of cover be available in the future for high risk and/or concentrated markets such as China, Brazil, South Africa, Oman, Philippines etc?

Our aim in providing cover is to maintain the risk-reward balance. This was a key commitment from the Mission and Status Review. Thus, if the risk is good we do not anticipate any additional problems in being able to meet the demand for cover.

What about riskier markets?

ECGD's stance in the riskier markets will need to be cautious as it is now, though capitalisation should allow greater flexibility. We do not expect to have to apply country ceilings – each case will be examined on its merits.

What about concentrated exposure markets such as China?

Where ECGD has a lot of exposure, such as China, its aim would be to seek to reduce it through active management of the exposure rather than, as at present, rationing new cover until risk runs off. Our strategy will be to reduce risk concentrations through our programme of Active Portfolio Management, thus enabling a reasonable level of new business to be done in these markets.

What information will you be giving to customers to help them in assessing whether they will be able to get ECGD support in particular markets?

We will be supplying information on both the likely response to indications by market and the current overall global cover availability. This will give customers some assurance as to the likelihood of cover/capital being made available if they are successful. This will be published regularly in our Newsletter and will be available on our Website.

Will the availability of cover on markets such as China depend on ECGD's success in transferring the risk, through active portfolio management and what happens if ECGD cannot transfer risk like this?

ECGD's expectation is that Active Portfolio Management will be achieved through post-issue activities conducted by ECGD. This is not to preclude, for very large cases (which consume significant capital), looking to the applicants to consider options, such as risk sharing, designed to reduce the likely capital consumption resulting from such risks. Initial soundings of the market have been positive, and although there is still some way to go in launching our APM programme, we are reasonably confident of success.

Will the capital be sufficient for an increased level of business?

We are confident that the capital with which ECGD will be endowed will be capable of supporting the projected levels of business, allowing for a degree of growth in the overall portfolio (of around 20%).

Will it impact on efficiency of our service delivery?

There have been some teething problems but these are being ironed out. Our aim is to ensure that the new internal systems that we are building will enable us to meet our Customer Charter standards for prompt response.

Annex 3: ECGD Mission Statement

Aim – To benefit the UK economy by helping exporters of UK goods and services win business and UK firms to invest overseas by providing guarantees, insurance and reinsurance against loss, taking into account the Government’s international policies.

Objectives –

- To achieve financial objectives set by Ministers.
- To operate in accordance with its business principles.
- To ensure its activities accord with other Government objectives, including those on sustainable development, human rights, good governance and trade.
- To promote an international framework that allows UK exporters to compete fairly by limiting or eliminating all subsidies and the adoption of consistent practices for assessing projects and countries on a multilateral basis.
- To recover the maximum amount of debt in respect of claims paid by ECGD in a manner consistent with the Government’s policy on debt forgiveness.
- To ensure ECGD’s facilities are, in broad terms, complementary to those in the private sector.
- To provide an efficient, professional and proactive service for customers which focuses on solutions and innovation.
- To employ good management practice to recruit, develop and retain the people needed to achieve the Department’s business goals and objectives.

Annex 4: Established Trading Funds

Central Office of Information
Companies House
Defence Evaluation and Research Agency
Defence Aviation Repair Agency
Driver & Vehicle Testing Agency Northern Ireland
Driving Standards Agency
Fire Service College
HM Land Registry
Medicines Control Agency
Meteorological Office
NHS Estates
Ordnance Survey
Patent Office
QE II Conference Centre
Registrars of Scotland
Royal Mint
The Buying Agency
UK Hydrographic Office
Vehicle Inspectorate

Annex 5: ECGD's Accounting Structure

ECGD's financial statements separately identify four main areas of activity:

- Account 1** Guarantees issued for project business prior to April 1991 and guarantees issued by the Insurance Services Group of ECGD (the main part of which was privatised on 1 December 1991) for which ECGD retains all contingent liabilities ('Insurance Services Business');
- Account 2** Guarantees for project business since April 1991, Overseas Investment Insurance guarantees and Tender To Contract business (all years), together with Reinsurance (Supplemental Reinsurance and Transitional Reinsurance) since the privatisation of the main part of the Insurance Services Group on 1 December 1991;
- Account 3** Guarantees issued, on the written instruction of Ministers, for project business since April 1991, which ECGD's Accounting Officer had advised did not meet normal underwriting criteria;
- Account 4** The provision of Fixed Rate Export Finance (FREF) to exporters of UK goods and services, together with arrangements for capital market funding of FREF loans and for interest rate swap arrangements.

Annex 6: ECGD's Premium System

- 1 ECGD operates its own systems for the assessment and pricing of risks, and sets premium rates to meet its Reserve Coverage Ratio (RCR) targets, agreed by Ministers. ECGD has an in-year RCR target to earn premium, net of administration costs, to cover 1.4 x Expected Loss; and an overall RCR target of reserves (Underwriting Funds and retained earnings) to Expected Loss of 1.5.
- 2 With a view to creating a more level playing field between different Export Credit Agencies (ECA's), in April 1999 OECD countries signed an Agreement which specifies minimum, risk based, premium benchmark rates for country and sovereign risk which is observed by all official ECAs in the OECD. Most of ECGD's sovereign premium rates are currently the same as the OECD minimum rates, but in certain markets where ECGD's assessment of the risk differs from the OECD, ECGD charges above the benchmark. The government's policy remains that rates should reflect risk.

Annex 7: Cabinet Office Code Of Practice on written consultation

The Cabinet Office code of practice on written consultation (the full text of which may be found on the Cabinet Office website at: www.cabinet-office.gov.uk/servicefirst/index/consultation.htm) requires all written consultation exercises undertaken by UK government departments to reflect the following criteria:

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage;
2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose;
3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain;
4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals;
5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation;
6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken;
7. Departments should monitor and evaluate consultations, designating a consultation coordinator who will ensure the lessons are disseminated.

Annex 8: Complaints

Any complaints about the way this consultation process has been conducted may be addressed to ECGD's Consultation Co-ordinator:

John Ormerod
Director of Strategy and Communications
Room 1529
ECGD
PO Box 2200
2 Exchange Tower
Harbour Exchange Square
London
E14 9GS

Telephone: 020 7512 7405

Annex 9: Glossary of Terms

APM		<u>Active Portfolio Management</u> – the mitigation of ECGD’s risks through arrangements with the private and/or international public sectors, resulting in a reduction in the Trading Fund’s capital consumption and associated cost of capital.
FREF		<u>Fixed Rate Export Finance schemes</u> , whereby ECGD supports the provision of fixed rate export finance to exporters of UK goods and services.
HIPCs		<u>Heavily Indebted Poor Countries</u> ;
Risk Management Review		In 1999, KPMG were awarded the contract to assess the adequacy of ECGD’s risk management systems and processes.
Mission & Status Review		Launched by the then Secretary of State for Trade & Industry, Stephen Byers in July 1999, it looked at ECGD’s objectives, role and status. It also addressed how ECGD’s activities related to the Government’s wider international objectives and whether the right balance was being struck between the benefits of ECGD’s support to UK exporters and investors and the need to safeguard the risks to the UK taxpayer.
Moratorium Interest		Interest due under International Debt Rescheduling Agreements.
MTM		<u>Mark to Market</u> – the valuation of certain assets and liabilities (usually those resulting from financial derivative or similar transactions) on the basis of the expected sale price of an asset or expected cost of settling a liability if settlement were to occur immediately.
Parliamentary Supply		The annual budgetary process by which Parliament scrutinises and controls expenditure by government departments;
Public Capital	Dividend	Capital, similar to equity, held by the Exchequer in Trading Funds;
RCR		<u>Reserve Coverage Ratio</u> – The ratio of cumulative reserves (underwriting funds and surpluses) to expected losses.
ROCE		<u>Return on Capital Employed</u> – The annual return generated by a business expressed as a percentage of the capital employed in supporting the net assets of that business;