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Mr K Soukup
Head of Unit
European Commission
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Markets and cases III: Financial Services
State aids II – Task Force Financial Crisis

Dear Mr Soukup,

CP 80/2010: Complaint against the UK export credit scheme

Introduction and Summary

1 I am writing in response to your letter of 12 July 2010 concerning the complaint that the Export Credits Guarantee Department ("**ECGD**") has provided unlawful state aid to the Guaranteed Export Finance Corporation PLC ("**GEFCO**").

2 ECGD is a UK government department and the UK's export credit agency ("**ECA**"). Its activities include guaranteeing loans from banks to foreign buyers to enable them to purchase goods and services from UK suppliers. In line with a number of other EU ECAs, ECGD is prepared to support, amongst other things, export credit loans made at an internationally agreed fixed rate of interest, known as the Commercial Interest Reference Rate ("**CIRR**"). The CIRR is determined in accordance with the provisions of the OECD Arrangement on Officially Supported Export Credits.

3 The EU ECAs providing support at CIRR do so through a variety of mechanisms: for some this will involve government-backed funding of the export loan. For others, including ECGD, the ECA provides interest rate support to the banks which fund the export loan. The mechanics of this ECA support, together with an explanation of ECGD's refinancing arrangements via GEFCO, are set out in Annex 2. ECGD only enters into refinancing arrangements after the relevant loan has been put in place and the sole purpose of these refinancing arrangements is to reduce the effective cost to ECGD/the UK government of supporting CIRR-based export loans, and thereby making savings for the benefit of the British taxpayer. The complaint alleges that these arrangements constitute unlawful state aid to GEFCO.

4 The UK considers that these arrangements do not give rise to state aid concerns, for the following reasons:

4.1 When the arrangements between ECGD and GEFCO are viewed in context, GEFCO should not be viewed as acting as an undertaking engaged in an economic activity for the purposes of article 107 of the Treaty on the functioning of the European Union ("**TFEU**"), and therefore GEFCO is outside the scope of the State Aid regime.

4.2 If, however, the Commission considers that GEFCO is an undertaking subject to the state aid regime, the Commission is invited to conclude that there has been no unlawful state aid to GEFCO, as the relevant criteria are not fulfilled.

4.3 Taking the arrangements between ECGD and GEFCO as a whole, GEFCO does not receive any benefit or advantage from the State as a result of these arrangements. The arrangements have the effect of reducing financing costs for ECGD and they require the economic benefit of such reduction to be passed back to ECGD. In particular, GEFCO makes no profit on the refinancing of loans guaranteed by ECGD, and for as long as it receives any support from ECGD it may not carry out any other economic activities. The very modest profits shown in its accounts result from interest earned on its original share capital.

4.4 ECGD's arrangements with GEFCO neither distort competition nor affect trade between Member States.

4.5 ECGD's use of refinancing through GEFCO was an economically rational decision which has resulted in an overall reduction in ECGD's costs and thus savings for the UK taxpayer.

4.6 ECGD no longer uses GEFCO for refinancing. The last refinancing transaction took place in 2003 and GEFCO's portfolio has been in run-off since that date. Since 2003, ECGD has entered into very few of the type of loans that were suitable for refinancing through GEFCO. Accordingly, ECGD does not intend to request GEFCO to refinance any other ECGD-guaranteed loans.

5 This letter sets out in more detail our arguments that the arrangements between ECGD and GEFCO do not constitute unlawful state aid and answers the specific questions contained in your letter of 12 July 2010. Detailed information about the arrangements between ECGD and GEFCO is contained in Annex 2 to this letter.

Response to State Aid Arguments

<u>GEFCO should not be classified as an "undertaking"</u>

6 When the arrangements between ECGD and GEFCO are viewed in context, GEFCO should not be viewed as an undertaking engaged in an economic activity, and therefore GEFCO is not subject to the state aid regime.

7 If ECGD were to undertake refinancing activity directly, without using GEFCO, this would fall within the sphere of state activity and would not be subject to review for state aid considerations. However, ECGD is governed by an Act of Parliament which prevents it from borrowing money, so it is impossible for ECGD to refinance loans by borrowing from the private market. Therefore ECGD has entered into arrangements with GEFCO

which allow it to make the costs savings associated with refinancing FREF Loans,[1] while complying with its Act of Parliament. For so long as GEFCO receives support from ECGD, it is prevented, by the contractual terms of that support, from undertaking any activity other than the refinancing of ECGD-guaranteed loans. The activity of refinancing the loan so as to reduce cost to ECGD is not in itself an economic activity. GEFCO does not offer or provide any service to anyone other than ECGD, and the service it provides to ECGD is non-profit-making.

8 Due to the nature of GEFCO's activities and its relationship with ECGD (refinancing FREF Loans which have been guaranteed by ECGD) and the contractual prohibitions on GEFCO undertaking any other activity, GEFCO does not place goods or services in a given market and it should therefore not be viewed as engaging in an economic activity for the purposes of article 107 of the TFEU. Accordingly, GEFCO should not be classified as an "undertaking" that is subject to the state aid regime.

9 In case the Commission disagrees with the analysis above, we have also reviewed the arrangements between ECGD and GEFCO on the basis that GEFCO were an undertaking subject to the state aid regime. We consider that any loans made by ECGD to GEFCO or any guarantees given by ECGD in respect of GEFCO's liabilities were not, and are not, incompatible with the internal market. In particular, the following criteria for unlawful state aid were not satisfied:

9.1 <u>No Benefit or Advantage</u>:

It is necessary to consider the relevant arrangements as a whole, and not take one part of a composite arrangement out of context.[2] It is also necessary to identify who has "actually benefited" from the alleged aid.[3] When the arrangements are viewed as a whole they do not confer a benefit upon GEFCO, as any surplus arising from the refinancing of a FREF Loan is passed back to ECGD. It is ECGD, not GEFCO, that ultimately receives the economic benefit from GEFCO's access to low-cost funding.

For the reasons given above, ECGD's arrangements with GEFCO for the purpose of refinancing FREF Loans are economically rational from ECGD's point of view, because they result in a saving for ECGD (and the UK taxpayer) overall. Market economy investors can, and do, provide loans and/or guarantees to special purpose vehicle ("**SPV**") companies in order to reduce the cost of borrowing for the SPV, for the ultimate benefit of the investor.

Although, over the past decade, GEFCO has made an annual profit of between £5,000 and £6,000, this is derived not from its refinancing activities, but from interest earned on its original share capital of £50,000 and on accrued retained profit.

Similarly, the arrangements between ECGD and GEFCO do not confer any benefit on the suppliers or purchasers under the export transactions to which the

[1] The type of loan that was refinanced through GEFCO is known as a "FREF Loan" and is described in more detail in Annex 2, paragraph 3.
[2] E.g. Case T-98/00 *Linde v Commission* [2002] ECR II-3961.
[3] Case C-457/00 *Belgium v Commission ("Verlipack")* [2003] ECR I-6931, para. 55.

refinanced FREF Loans relate. Their liabilities (under the export transactions and FREF Loans) remain unaffected by the refinancing arrangements.

The complaint alleges that the arrangements between ECGD and GEFCO (1) permit GEFCO to access capital at rates below market rates, and (2) obviate the need for GEFCO to set aside assets as collateral against credit, interest rate, currency and market risks and that, as a result, GEFCO has a competitive advantage over other undertakings operating in the capital markets. If GEFCO can properly be said to operate in the capital markets, it does so to benefit ECGD. Where ECGD guarantees GEFCO's obligations, the terms on which GEFCO may borrow or enter swaps are commensurate with that risk.

GEFCO may not use ECGD's guarantee to raise money on behalf of third parties or for purposes other than refinancing FREF Loans at ECGD's request.

9.2 No Distortion of Competition:

The loans and guarantees provided by ECGD to, or for the benefit of, GEFCO do not distort, or threaten to distort, competition as GEFCO is not in competition with other undertakings. The terms of the arrangements between ECGD and GEFCO restrict GEFCO's activities to refinancing ECGD-supported loans for as long as GEFCO receives any support from ECGD, so GEFCO cannot use its arrangements with ECGD in order to compete with banks or other financial institutions for any other kind of business. Therefore ECGD's arrangements with GEFCO result in a benefit for ECGD only, and do not distort, or threaten to distort, competition.

The complaint alleges that the arrangements between ECGD and GEFCO give GEFCO a monopoly in the market for refinancing ECGD-guaranteed loans. No such market has ever existed. In any event, the last refinancing took place in 2003 and there are no plans to refinance any further FREF Loans.

9.3 No Impact on Trade between Member States:

The loans and guarantees provided by ECGD to, or for the benefit of, GEFCO did not affect, and are not capable of affecting, trade between Member States. The refinancing of FREF Loans took place only after the relevant FREF Loans had been made and did not alter the terms of, or the amounts or timing of payments under those loans and therefore gave no benefit or advantage to the relevant borrowers or exporters (who were unaware that the refinancings had taken place). The effect of the refinancings is simply to make savings for ECGD and, indirectly, the British taxpayer.

Responses to Questions

10 The questions in your letter are set out below, together with our responses. These responses explain the current situation, as well as that which prevailed five years ago.

11 Question 1: *What is the ownership structure of GEFCO? In particular, please clarify the apparently mutually contradicting information provided in the complaint form, point 4c, pages 6 to 7. Could you please also specify the ultimate parent of GEFCO and area of its activities?*

12 GEFCO has issued 50,000 £1 shares. Of these 49,999 shares are held by First Securitisation Company Limited ("**FSCL**") and one share is held by Capita IRG Trustees Limited. FSCL has issued two £1 shares, both of which are held by Capita Trust Nominees No. 1 Limited. Five years ago, GEFCO's shareholders were the same as they are today, but FSCL's shares were held by Capita IRG Trustees Limited. A diagram setting out these shareholdings is attached as Annex 1 to this letter.

13 GEFCO's ultimate parent company is FSCL. Neither GEFCO nor FSCL form part of the group of companies owned by The Capita Group PLC as FSCL's shares are held on trust for certain discretionary beneficiaries and ultimately on trust for charities. FSCL's principal activity is that of a holding company. This situation is the same today as it was five years ago.

14 Some of the contradictory information as to the identity of the shareholders may be due to the fact that the identity and names of the Capita shareholders has changed over the years. In addition, the return filed with Companies House which the Complainant submitted with its evidence identified GEFCO's shareholders and their respective shareholdings incorrectly. A return showing the correct details was filed on 28th July 2010.

15 <u>Question 2</u>: *Referring to the letter of the complainant of 10 May 2010, point 1, please explain what the legal status of the alleged beneficiary is. In particular, please clarify if GEFCO is a non-profit entity*.

16 GEFCO is a public limited company, incorporated in Great Britain, registered in England and Wales and domiciled in the United Kingdom. GEFCO's memorandum and articles of association allow it to make profit. However, as mentioned in the response to question 6 below, GEFCO only makes a very limited amount of profit each year, and its refinancing activities are not profit-making.

17 <u>Question 3</u>: *Could you please provide us with details related to the area of GEFCO's activity? Is it limited only to the refinancing of ECGD or does GEFCO undertake other activities?*

18 The contractual arrangements between ECGD and GEFCO stipulate that, for as long as GEFCO receives support from ECGD, GEFCO may not, without ECGD's consent, enter into transactions except for the purpose of refinancing loans guaranteed by ECGD. [4] Accordingly it does not undertake other activities.

19 <u>Question 4</u>: *Please explain the current refinancing mechanism and the reasons why this approach has been chosen instead of the possibility for ECGD to refinance itself directly on the private market?*

20 There is no current financing mechanism as ECGD has not requested GEFCO to refinance any export credit loans guaranteed by ECGD since 2003 and the portfolio of sub-participated loans held by GEFCO has been in run-off since that date.[5] ECGD does not intend to request GEFCO to refinance any other ECGD-guaranteed loans.

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[4] GEFCO has never made a request to ECGD to enter into other types of transactions. If GEFCO were to make such a request, ECGD would almost certainly refuse it, due to state aids considerations and unacceptable additional risk which ECGD would incur.

[5] All existing refinanced FREF Loans (and the corresponding loans from ECGD to GEFCO) should be repaid by 2022 with 50% of the principal outstanding under those FREF Loans being repaid by 2013.

21 The means by which FREF Loans were refinanced by GEFCO is described in paragraphs 5 to 11 of Annex 2.

22 ECGD's activities are governed by the Export and Investment Guarantees Act 1991 (as amended by the Industry and Exports (Financial Support) Act 2009). Section 3(3) of that Act contains a prohibition on ECGD entering into any transaction for the purpose of borrowing money. Therefore it is not possible for ECGD to refinance loans by borrowing from the private market.

23 Question 5: *Please indicate all types of State support GEFCO has received during last ten years.*

24 The types of State support which GEFCO has received during the last ten years are:

24.1 guarantees by ECGD in respect of bonds issued by GEFCO (the final bond was issued in 1993 and repaid in full in 2010);

24.2 two loans granted by ECGD to GEFCO;

24.3 guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO;

24.4 a guarantee of GEFCO's obligations under its overdraft facility; and

24.5 reimbursement of the costs and expenses (for example management, legal and audit fees and transaction costs) which GEFCO incurs in refinancing loans at ECGD's request.

25 Further details about these types of support are set out in paragraphs 6 to 14 of Annex 2.

26 Question 6: *Could you please provide us with the information on the annual profits generated by GEFCO in the last 10 years and indicate whether they were distributed to shareholders or used otherwise?*

27 Over each of the past ten years, GEFCO has reported an annual profit of £5,000 or £6,000. This profit was derived from interest earned on GEFCO's original share capital of £50,000 and on accrued retained earnings from the reinvestment of this capital. GEFCO's profits have not been distributed to shareholders but have been kept within GEFCO as retained profits.

Conclusion

28 For the reasons set out in paragraph 4 and explained further in this letter, we hope that we have addressed the Commission's questions in full, but if I can be of any further assistance on this matter, please do not hesitate to contact me.

Yours sincerely,

Bill Jones

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