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Ditte Juul-Jørgensen
Head of Unit
Directorate-General for Trade
European Commission
B-1049 Brussels
BELGIUM

27 October 2010

Your ref: TRADE F.2/LT/ba

Dear Mr Juul- Jørgensen

Ref: CHAP (2010) 02320 - Complaint against the UK export credit scheme

Thank you for letter of 30 September 2010.

1. As we understand it, DG Trade has concluded that there are insufficient grounds to pursue its investigation of our Complaint that the Export Credits Guarantee Department (ECGD) breaches the break-even requirements of the WTO's Agreement on Subsidies and Countervailing Measures (ASCM) concerning export subsidies by removing the operating costs of refinancing its loss-making Fixed Rate Export Finance (FREF) scheme through the use of an off-balance sheet special purpose vehicle, the Guaranteed Export Finance Corporation (GEFCO).

As we understand it, DG Trade has taken this view because:

- 1.1 The ECGD's Fixed Rate Export Finance (FREF) Scheme is an interest rate support scheme and not an export credit or export guarantee scheme and is not therefore subject to the "break even" requirement established in Annex I, item j of the World Trade Organisation's Agreement on Subsidies and Countervailing Measures (ASCM);
- 1.2 Whilst not specifically referring to interest rate schemes, the ASCM, does, however, require FREF-like schemes to be operated in line with the OECD Arrangement on Export Credits, if they are not to be considered subsidies. FREF is operated in line with the Arrangement and is not therefore a subsidy.
2. If we have misunderstood your reasoning, we would request that you inform us as soon as possible, so that we can respond accordingly.
3. Assuming, however, that we have understood your argument correctly, we would respectfully submit that the ASCM's break even clause does in fact apply to FREF and that ECGD's refinancing of FREF loans through GEFCO is, as a matter of fact and of law, in breach of both the ACSM and the OECD Arrangement.
4. We are therefore writing to provide further supporting information for our Complaint and to clarify a number of points where there appear to be misunderstandings. For ease of reference, we have quoted extracts from your response first and then replied to them below.

FREF AND THE ASCM BREAK-EVEN REQUIREMENT

To our knowledge, FREF is not an export credit guarantee or insurance scheme, but an interest rate support scheme. As you are aware, the "break-even requirement" established in Annex I, item j of the ASCM does not refer to such interest rate support schemes.

5. We respectfully submit that it is incorrect to characterise ECGD's Fixed Rate Export Finance Scheme (FREF) as an interest rate support scheme. As its full name suggests, it is an export finance scheme, the export finance loans being provided through export credit guarantees that have accompanying "Interest Make-Up" (IMU). FREF loans differ from other export credit guarantees only in so far as the interest rate on the export credit loan is fixed. As such, it is no less of an export

credit guarantee than, say, a fixed-rate mortgage is less of a mortgage than a variable rate mortgage.

5.1 In its response to DG Competition, attached as Annex 1 of this letter, the UK Representation to the EU Brussels describes FREF as “export credit loans made at an internationally agreed fixed rate of interest” (emphasis added).¹

5.2 The ECGD also acknowledges that FREF-type loans constitute export credits. It states:

“several countries continue to provide a large portion of their export credit support in the form of IMU”.²

5.3 ECGD also specifically describes FREF loans as export credit guarantees. For example, ECGD variously states:

“ECGD provides FREF support in the form of interest equalisation arrangements between itself and the lending bank. In essence, the lending bank funds its export credit loan over a series of interest periods (typically of six months’ duration) at market-based floating rates of interest, but makes the loan available to the overseas borrower at a fixed rate of interest”³ (emphasis added);

“ECGD is the UK’s official export credit agency (“ECA”). Its principal role is to facilitate supplies of goods and services by persons carrying on business in the UK to persons overseas. One of the ways it does this is by providing guarantees to banks which provide loans to overseas borrowers to finance the purchase of UK goods and services . . . Finance in respect of these guarantees may be provided either at fixed or floating rates of interest determined by the lending bank based on prevailing market rates (“Pure Cover”) or, subject to certain criteria, in the form of FREF support”⁴ (emphasis added);

“Under ECGD’s FREF Scheme: A bank makes an export credit loan to a borrower outside the UK to enable it to purchase goods and services supplied by a British company. That loan is made at a fixed rate of interest which is determined according to the applicable commercial interest reference rate published by the OECD (the “CIRR”). In order to enable the relevant bank to make a loan at that fixed rate of interest (a “FREF Loan”), ECGD agrees with the bank that: the bank will fund the loan on a short term basis between one interest payment date and the next (typically, a period of six months) by borrowing the required amount every six months from the inter-bank market at the then current London Inter-bank Offered Rate (“LIBOR”); if, at the end of any funding period, the cost to the bank of

funding the loan at LIBOR over that period (plus the bank's margin) is more than the CIRR interest payable in respect of that period by the borrower under the relevant export credit loan, ECGD will pay the shortfall to the bank; and conversely, if, at the end of any funding period, the cost to the bank of funding the loan at LIBOR over that period (plus the bank's margin) is less than the CIRR interest payable by the borrower under the export credit loan, the bank will pay the surplus to ECGD.”⁵

- 5.4 ECGD also specifically refers to the loans refinanced through GEFCO, whose arrangements with ECGD are the subject of the Complaint, as “export credit loans”.⁶
- 5.5 We would contend that, as export credit guarantees, which differ from pure cover only in having Interest Make-Up (IMU), FREF loans clearly fall within the category of export credit subsidies that are regulated under Annex I (j) of the ASCM. As such, they are subject to Annex I (j)'s break even requirement. The premiums set for FREF loans must therefore be adequate to cover the long-term operating costs and losses of the programme, including the operating costs of refinancing FREF loans.
- 5.6 On the basis of the information supplied above, we would request that DG Trade reconsiders its decision that FREF loans are not subject to Annex 1 (j).

FREF AND THE OECD ARRANGEMENT

“While [Annex I (i) of the ASCM] provides only an indicative list of export subsidies, it establishes under Paragraph 2 of item k that export credits practices, which are in line with the OECD Arrangement on Export Credits or a similar international undertaking, should not be considered as export subsidies prohibited under the ASCM. To our knowledge “FREF” is in line with the OECD Arrangement on Export Credits and therefore consistent with the ASCM.”

- 6 We agree that FREF is subject to the OECD Arrangement on Export Credits, both for the reasons given above and because, as an official export credit guarantee provided by an OECD member state, it falls under the Arrangement as a matter of course. As such, the ECGD is not only required to ensure that FREF is run in accordance with the Arrangement's provisions on Commercial Interest Reference Rates but also with the Arrangement's own break even requirements.⁷ These requirements are legally-binding through the EU's adoption of the ASCM.

- 7 We disagree strongly, however, with DG Trade’s conclusion that FREF is run in line with the OECD Arrangement, for the following reasons:
- 8 To comply with the break even requirements of the OECD Arrangement and the ASCM, ECGD must ensure that the premiums it charges for FREF loans are adequate to cover the scheme’s operating costs and losses in the long-term. However, ECGD’s accounts do not include the operating costs of refinancing FREF export credit loans, even though such refinancing is clearly critical to the effective operation of the scheme. In addition, the liabilities (and thus potential losses) attendant on the risks of refinancing feature only in GEFCO’s accounts, even though, as documented in the Complaint, and as accepted by the UK,⁸ they are guaranteed in full by ECGD. As a result, the premiums charged by ECGD do not need to reflect the risks of such liabilities turning into losses, as required by the ASCM and the OECD Arrangement.

9 Operating Costs of Refinancing FREF removed from ECGD’s accounts

- 9.1 As explained in our Complaint, the operating costs of refinancing FREF (as opposed to making the original FREF loans) are borne entirely by GEFCO, which ECGD has established as an off balance sheet special purpose vehicle. We note that the UK’s response to DG Competition acknowledges that the operating expenses incurred by GEFCO in the refinancing of ECGD’s FREF loans are deducted from any surplus arising from GEFCO’s interest income, *prior* to that surplus being paid to ECGD.⁹ This prior deduction is confirmed in ECGD’s Annual Resource Accounts for 2008-2009, which state:

“Under the contracts for the refinancing of export credit loans, ECGD has agreed that, at the end of each month GEFCO will deduct from the principal and interest payable to ECGD any expenses incurred by GEFCO in administering the refinanced loans”.¹⁰

- 9.2 ECGD’s accounts also confirm that no payments are made for GEFCO’s services, the only transactions between ECGD and GEFCO that are recorded for 2008-09 being net repayments of principal under loans made by ECGD to GEFCO and net interest received under those loans.¹¹

9.3 As a result, the costs of operating the FREF refinancing scheme would appear to be removed entirely from ECGD's accounts. If these costs were booked to the ECGD, as they should be if ECGD is to comply with the Arrangement and with the ACSM, ECGD's operating costs would rise, on ECGD's own figures, by at least £2,826,000 a year,¹² a figure that does not include any management fees charged by GEFCO.¹³ The sum involved represents approximately 12 per cent of ECGD's declared operating costs.¹⁴ In effect, these operating costs would, if GEFCO's operations were consolidated with ECGD's, rise by at least 12 per cent, potentially requiring higher premiums to be charged if those premiums were to cover long-term operating costs and losses.

10. Liabilities removed from ECGD's books even though guaranteed by ECGD

10.1 We would also point out that by placing the refinancing of its FREF loans off balance sheet, ECGD also removes the liabilities associated with the credit risks of the refinancing operation. GEFCO's own valuations of such liabilities for 1999 through to 2009 are set out below (all figures are for 31 March of the given year):

1999	£1,486.4 million ¹⁵
2000	£2,591.3 million ¹⁶
2001	£3,923.6 million ¹⁷
2002	£3,774.9 million ¹⁸
2003	£3,633.5 million ¹⁹
2004	£2,856.6 million ²⁰
2005	£2,292.4 million ²¹
2006	£2,973.1 million ²²
2007	£1,969.5 million ²³
2008	£1,018.6 million ²⁴
2009	£ 822.9 million ²⁵

10.2 We note that ECGD has accepted that it guarantees GEFCO in full for these liabilities.²⁶ Because GEFCO's accounts are not consolidated with those of ECGD, however, ECGD does not have to make provision in its own accounts for the liabilities it guarantees on GEFCO's behalf, distorting its true financial position. Again, the effect is to permit ECGD to charge lower premiums than it would otherwise be obliged to charge were the risks

associated with those liabilities to be taken into account when setting premiums.

11. For the above reasons, we would contend that, by removing the operating costs of the FREF refinancing operation from its accounts, together with the associated liabilities, ECGD is clearly in breach of both Article 22 of the Arrangement and Annex I (j) of the ASCM, since ECGD's current arrangement with GEFCO permits it to charge lower premiums than would be required if it had to cover its true operating costs and losses for FREF.

ECGD and Article 1.1 (a) (1) (iv) of ASCM

- 11 If DG Trade disagrees with the analysis and evidence presented above and concludes that the ECGD's refinancing arrangements with GEFCO for its FREF export credit loans do not contravene Annex 1 (j) of the ASCM and Article 22 of the OECD Arrangement, we would request that DG Trade considers the further contravention alleged in our Complaint, namely that of Article 1.1 (a) (I) (iv) of ASCM.
- 12 As noted in our Complaint, ASCM prohibits governments from making payments to a funding mechanism, or entrusting or directing a private body to carry out one or more of the type of functions "*which would normally be vested in the government*" and where "*the practice, in no real sense, differs from practices normally followed by governments.*"²⁷
 - 12.1 The UK does not deny providing State support to GEFCO: on the contrary, it acknowledges doing so.²⁸ However, it argues that such support is legitimate because the ECGD is forbidden under UK law from borrowing on the private market whereas GEFCO is not, enabling GEFCO to refinance FREF loans more cheaply than would be the case if the refinancing was undertaken by ECGD itself. In effect, according to the UK, GEFCO is carrying out a function that could not be performed by the ECGD.²⁹
 - 12.2 However, it is clear from the UK's response to our Complaint that GEFCO has long ceased to borrow on the private market, its last bond being issued in 1993³⁰ – outside of the period covered by the Complaint. Indeed, on the

ECGD's own admission, all borrowings by GEFCO since 1999 have consisted of loans from ECGD, not monies raised on the private market.³¹

12.3 The justification for using GEFCO as a vehicle for refinancing thus no longer holds, since GEFCO is no longer borrowing on the private market. There is consequently no reason why ECGD could not refinance the FREF loans on its own account.

12.4 We would therefore contend that the arrangement between ECGD and GEFCO has been in breach of the ASCM from at least 1999 and consequently in breach of EU State Aid rules, precisely because GEFCO has been performing a function that could – and should – be performed by ECGD and which, to our knowledge, is performed by many other export credit agencies without the use of an off balance sheet vehicle such as GEFCO. In effect, the method of refinancing used since 1999 is *“a practice [that], in no real sense, differs from practices normally followed by governments”*.

12.5 Even if, as stated by the UK, ECGD is no longer using GEFCO to refinance new FREF loans, the existing loans held by GEFCO are still being paid off. Their management by GEFCO is therefore still in contravention of ASCM rules. We would contend that ECGD should be required to relinquish GEFCO's management of the loans and that their control be returned to ECGD.

CONCLUSION

13. For the reasons set out above, we would request that you reconsider your decision not to investigate our Complaint further. Please do not hesitate to contact us if you require further information.

Yours Sincerely

A handwritten signature in blue ink, reading "Nicholas Hitchcock", is enclosed in a light blue rectangular box with a thin black border.

Nicholas Hildyard
The Corner House



Ann Feltham
Campaign Against Arms Trade

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- 1 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 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”).”
 - 2 Export Credits Guarantee Department, “Consultation on ECGD support for fixed rate export finance”, para 65.8, http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/consultations/support-for-fixed-rate/2005_fref_consultation.pdf.
 - 3 Export Credits Guarantee Department, “Consultation on ECGD support for fixed rate export finance”, para 26, http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/consultations/support-for-fixed-rate/2005_fref_consultation.pdf
 - 4 Export Credits Guarantee Department, “Consultation on ECGD support for fixed rate export finance”, paras 23-24, http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/consultations/support-for-fixed-rate/2005_fref_consultation.pdf.
 - 5 “Background on GEFCO and ECGD”, paper supplied by ECGD and appended to Letter from DG Competition to The Corner House and Campaign Against Arms Trade, 1 October 2010, para 3.3.
 - 6 ECGD, Annual Resource Accounts 2008-09, p.108 <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>:

“. . . GEFCO refinanced a number of export credit loans guaranteed by ECGD.”
 - 7 OECD, “Arrangement on Officially Supported Export Credits”, http://www.oecd.org/departement/0,3355,en_2649_34171_1_1_1_1_1,00.html, para 22:

“The Participants shall charge premium, in addition to interest charges, to cover the risk of non-repayment of export credits. The premium rates charged by the Participants shall be risk based, shall converge and shall not be inadequate to cover long-term operating costs and losses”.
 - 8 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 24:

“The types of State support which GEFCO received during the last ten years are . . . guarantees by ECGD in respect of bonds issued by GEFCO . . . two loans granted by ECGD to GEFCO . . . guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO . . . a guarantee of GEFCO’s obligations under its overdraft facility . . . and reimbursement of the costs and expenses . . . which GEFCO incurs in refinancing loans at ECGD’s request.”
 - 9 Background on GEFCO and ECGD, appended as Annex 2 in Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 7:

“Under the refinancing arrangements between ECGD and GEFCO, any surplus arising as a result of the interest received by GEFCO under the refinanced FREF Loans exceeding the interest payable by GEFCO under the bonds was, after deduction of the costs incurred by GEFCO in managing the refinanced loans, paid to ECGD.”
 - 10 ECGD, Resource Accounts 2008-09, page 108, <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>.
 - 11 ECGD, Annual Resource Accounts 2008-09, p.108 <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>

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- 12 ECGD, Annual Resource Accounts 2008-09, p.108, <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>:
“Under the contracts for the refinancing of export credit loans, ECGD has agreed that, at the end of each month GEFCO will deduct from the principal and interest payable to ECGD any expenses incurred by GEFCO in administering the refinanced loans. In the financial year ended 31 March 2009, those deductions totalled £2,826,000 (£2,725,000 in 2007-08).”
- 13 ECGD, Annual Resource Accounts 2008-09, p.108, <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>:
“The expenses deducted include: interest payable to Lloyds under the overdraft facility; fees payable by GEFCO to Lloyds for managing the refinanced loans; and residual margin payments made to banks on ECGD’s behalf pursuant to the Agency Agreement between ECGD and GEFCO.”
- 14 ECGD, Annual Resource Accounts 2008-09, pp.93 and 95, <http://www.ecgd.gov.uk/assets/bispartners/ecgd/files/publications/ann-reps/ecgd-resource-accounts-2008-09.pdf>
ECGD’s declared staff costs (which do not include GEFCO’s staff expenditures) in 2008-09 were £11,326,000. Other administrative and operating costs, again omitting GEFCO’s, totalled £11,601,000.
- 15 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 1999”, “Balance sheet at 31 March 1999, p.6.
- 16 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2000”, “Balance sheet at 31 March 2000, p.7.
- 17 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2001”, “Balance sheet at 31 March 2001, p.7.
- 18 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2002”, “Balance sheet at 31 March 2002, p.7.
- 19 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2003”, “Balance sheet at 31 March 2003, p.7.
- 20 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2004”, “Balance sheet at 31 March 2004, p.6.
- 21 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2005”, “Balance sheet at 31 March 2005, p.6.
- 22 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2006”, “Balance sheet at 31 March 2006, p.7.
- 23 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2007”, “Balance sheet at 31 March 2007, p.7. We note that a lower figure (£1,427.2 million) for 2007 is given in GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2008”, Note 18, “Financial Risk Management – Credit Risk Management”, p. 17.
- 24 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2008”, Note 18, “Financial Risk Management – Credit Risk Management”, p. 17.
- 25 GEFCO, “Report of the Directors and Financial Statements for the Year Ended 31 March 2009”, Note 18, “Financial Risk Management – Credit Risk Management”, p. 16.
- 26 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 24:
“The types of State support which GEFCO received during the last ten years are . . . guarantees by ECGD in respect of bonds issued by GEFCO . . . two loans granted by ECGD to GEFCO . . . guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO . . . a guarantee of GEFCO’s obligations under its overdraft facility . . . and reimbursement of the costs and expenses . . . which GEFCO incurs in refinancing loans at ECGD’s request.”
- See also:*
Background on GEFCO and ECGD, appended as Annex 2 in Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 14.
- 27 World Trade Organisation, Agreement on Subsidies and Countervailing Measures, Part 1: General Provisions, Article 1.1 (a) (1) (iv), http://www.wto.org/english/docs_e/legal_e/24-scm.pdf.

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- 28 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 24:

“The types of State support which GEFCO received during the last ten years are . . . guarantees by ECGD in respect of bonds issued by GEFCO . . . two loans granted by ECGD to GEFCO . . . guarantees by ECGD to parties which enter into cross-currency swaps with GEFCO . . . a guarantee of GEFCO’s obligations under its overdraft facility . . . and reimbursement of the costs and expenses . . . which GEFCO incurs in refinancing loans at ECGD’s request.”

- 29 Letter from Bill Jones, First Secretary, Competition, UK Representation to the EU Brussels, to DG Competition, undated, para 22.

- 30 Background on GEFCO and ECGD, appended as Annex 2 in Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 8.

- 31 Background on GEFCO and ECGD, appended as Annex 2 in Letter from DG Competition to The Corner House and CAAT, 1 October 2010, para 10:

“From 1999 onwards, refinancing of FREF Loans were funded by loans made by ECGD to GEFCO under the terms of the Direct Funding Loan Agreement”.