All Party Parliamentary Group on International Corporate Responsibility

Investigation into the workings of UK Export Finance

Submission by The Corner House

INTRODUCTION

1. The Corner House is a not-for-profit research and advocacy group, focusing on human rights, environment and development.
2. Over the past 13 years, The Corner House has closely monitored the support given to UK industry by the UK Export Credits Guarantee Department (ECGD), now UK Export Finance (UKEF), participating in nine field missions to assess the social and environmental impacts of several projects for which ECGD support had been sought. It has also undertaken in-depth research into a number of ECGD-backed projects that have been tainted by allegations of bribery.
3. The Corner House welcomes the All Party Parliamentary Group's current inquiry into the workings of UKEF and is grateful for the opportunity to comment on the issues that the Group has chosen to examine.
4. The Corner House commends the submissions and recommendations made by Jubilee Debt Campaign, Amnesty UK, Campaign Against Arms Trade, WWF and the CORE Coalition/University of Essex/University of Melbourne. In particular, The Corner House supports calls for:
    - The adoption of mandatory human rights and environmental standards, against which all applications for ECGD/UKEF support should be assessed, to ensure that ECGD/UKEF complies with wider government policy on human rights, the environment and sustainable development;
    - Amendments to the Act of Parliament governing ECGD/UKEF so that it includes a clause mandating a 'duty of care' towards those affected by ECGD/UKEF-supported projects;
    - A prohibitions list of activities that ECGD/UKEF will not support because they are not conducive to sustainable development, including the export of arms;
    - A public audit of all the debts owed to ECGD/UKEF, and cancellation of those debts generated by unjust loans;
    - The incorporation of ECGD/UKEF into the Green Investment Bank as part of a wider industrial strategy aimed at building a low-carbon economy in the UK.
5. Rather than repeat points already made by others, this submission focuses on:
    - Concerns that the use of a Treasury-financed, off balance sheet vehicle may be hiding both the extent of ECGD/UKEF's liabilities and its use of taxpayer funds to cover its operational expenses;
    - The failure of UKEF to have in place procedures that would enable it to comply with its legally-binding obligations (notably with respect to human

rights) under Article 21 of the Lisbon Treaty.

HOW MUCH DOES ECGD/UKEF COST THE TAXPAYER?

6. The UK Treasury is ultimately responsible for "*backstopping*" all of ECGD/UKEF's business, whose credit risk exposure (that is, the amount for which taxpayers' are ultimately liable) currently stands at an estimated £16 billion.
7. In the 1980s, ECGD regularly incurred substantial operating losses. Loans made during this period are estimated to have cost the taxpayer some £9 billion (including interest due).
8. Since 1991, however, ECGD/UKEF has been subject to a non-statutory policy objective, set by Ministers, of operating "*at no net cost to the tax-payer*".[1] As a result, ECGD/UKEF is required to finance its operating expenses out of its income. Indeed, the UK Government is legally bound under EU law[2] and by the World Trade Organisation (WTO)'s Agreement on Subsidies and Countervailing Measures (ASCM) to ensure that the premiums charged by ECGD/UKEF are adequate to cover the long-term operating costs and losses of its programmes (although what constitutes the "*long-term*" is not defined).
9. ECGD/UKEF claims that "*in the last ten years, ECGD has met financial objectives set for it by HM Treasury*".[3] In particular, ECGD states that over "*most of its history*", it has "*operated with a surplus*", with premium income exceeding the amounts paid out in claims. In 2010-11, that surplus was put at £204 million.
10. ECGD/UKEF also states that its premiums are "*priced to risk*" and sufficient to meet both expected and unexpected losses.
11. Close scrutiny of ECGD's accounts, however, casts serious doubt about claims that the Department's expenses are covered by its premium income and about its stated liabilities to the taxpayer.
12. **Of particular concern is ECGD/UKEF's use of a Treasury-financed, off-balance sheet vehicle – the Guaranteed Export Finance Corporation (GEFCO) – to refinance ECGD's loss-making (but only recently discontinued) Fixed Rate Export Finance (FREF) scheme. Since 1999, the taxpayer has been tapped for several billion pounds in loans to enable this refinancing operation. Yet these loans do not appear to feature as liabilities on ECGD's balance sheet and the costs of operating the refinancing scheme are covered through the Treasury's loans rather than premium income.**
13. By way of background:

a) <u>FREF</u>

- ECGD's (FREF) scheme has been used to provide "*export finance assistance through interest support*." Under the scheme, ECGD-approved banks provided fixed rate loans to the overseas buyers of UK exports. The banks borrowed at floating, market-based interest rates, but ECGD covered any losses that the banks incurred due to the difference between the fixed rates at which they lent and the floating rates at which they are borrowed. If a bank provided a loan to an overseas buyer at a fixed rate of, say, 5% per annum, but funded the loan at market-based floating rates of 10%, EGCD covered the 5% difference. Conversely, the bank paid ECGD if the floating rate was less than the fixed rate.

- The Treasury has described the losses incurred through FREF as "*massive*"; in 2004, it estimated that the scheme (which it described as a "*subsidy*"[4]) had cost the taxpayer more than £15 billion since 1972.[5] An independent report, commissioned by ECGD itself, has also acknowledged the subsidy element in FREF, which it put at £641-741 million between 1992 and 2000[6] – a figure that does not include Treasury support for the refinancing of FREF loans.

- Despite the huge losses incurred through FREF, ECGD's FREF business was not included in its financial statements until 1999. Its 1997/98 Resource Accounts state:

  > "*ECGD performs other functions, accounted for as Public Expenditure, **which are not included in these financial statements**. These consist of the provision of Fixed Rate Export Finance to exporters of UK goods and services, together with arrangements for capital market funding of fixed rate export finance loans and of certain interest rate swap arrangements: Tender to Contract Cover and the administration of certain discounted credit insurance facilities*" (emphasis added).[7]

- In March 2011, the ECGD announced the termination of the FREF scheme. Subsequently, the Secretary of State for Business, Innovation and Skills, Vince Cable, told a parliamentary committee that one of the reasons for discontinuing FREF was that "*it enjoyed an implicit taxpayer subsidy*."[8]

b) GEFCO

- The Guaranteed Export Finance Corporation (GEFCO) is a public limited company, registered and domiciled in the UK (company no: 01980873).
- GEFCO's main activity – and the purpose for which it was established – is to refinance loans supported or guaranteed by ECGD. GEFCO achieves this activity by raising funds "*through the capital markets, from ECGD and from banks*". GEFCO also trades in financial instruments, including derivatives, "*to reduce its exposure to fluctuations in interest and foreign exchange rates*".
- The company is contractually bound by an agreement with ECGD not to undertake business other than with ECGD.
- GEFCO was originally set up in 1986, with the express purpose of circumventing government rules prohibiting ECGD from raising funds on capital markets. Instead of ECGD borrowing from the private markets, GEFCO would do so, with the money then being used to finance ECGD's refinancing activities. GEFCO is also able to hedge foreign exchange risks through derivative swaps, which ECGD is forbidden by the Treasury from doing.
- Prior to 1999, GEFCO raised funds from the international bond market, with an unconditional repayment guarantee from ECGD, but without the borrowings being counted against the Public Sector Borrowing Requirement (PSBR). In 1999, however, the UK Office of National Statistics ruled that the bonds should be counted as part of the UK Government's debt, since they were guaranteed by ECGD. Since GEFCO did not have sufficient funds to pay the bond principals on maturity, ECGD loaned the company £263 million to cover the shortfall.
- Since 1999, GEFCO's repurchases of FREF loans have been financed from public funds voted through by Parliament. The funds are loaned to GEFCO by the Treasury, via ECGD. The loan facility was originally set at £1 billion under an agreement dated 9 July 1999. The size of the facility was later increased, reaching £4.8 billion in 2006. Not all of the facility has been

drawn upon each year. Nonetheless, the actual sums voted annually to ECGD to support GEFCO's activities since 1999 have been considerable, totaling over £3.7 billion. HM Treasury gives the following figures:

- 1999-2000: £777,059,000
- 2000-2001: £1,077,919,000
- 2001-2002: £235,124,000
- 2002-2003: £1,000,000,000
- 2003-2004: £166,803,000
- 2004-2005: £179,125,000
- 2005-2006: £116,922,000
- 2006-2007: £76,459,000
- 2007-2008: £49,408,000
- 2008-2009: £37,006,000
- 2009-2010: £24,599,000
- 2010-2011: £1,055,000
- 2011-2012: £10,699,000
- 2012-2013: £10,320,000

• Under an arrangement between the Department for Business, Innovation and Skills (BIS) (and its predecessor departments), all of GEFCO's liabilities are guaranteed "*unconditionally and irrevocably by BIS, acting through ECGD"*.[9]

• These liabilities include:
  - GEFCO's overdraft with Lloyds Banking Group Plc;
  - any losses arising from cross currency swaps;
  - other loans and derivative trades which GEFCO has entered into in order to refinance ECGD's export credit loans; and
  - any adverse fluctuation in the fair value of GEFCO's assets. GEFCO does not appear to pay any premium for the guarantees it receives.

• GEFCO has undertaken no new refinancing of FREF loans since 2002; as FREF closed as an ECGD programme in March 2011, the scheme is now in run-off. As a result, GEFCO's potential liabilities have been reduced from £3.7 billion in 2002 to £263 million in 2011. But the actual liabilities of GEFCO may be higher than stated, due to the difficulties of accurately assessing the risks involved with derivative instruments, such as interest rate swaps and currency exchange swaps. No financial assets have been pledged as collateral against GEFCO's liabilities, all the risks falling on ECGD.

• Despite GEFCO neither offering nor providing any service to anyone other than ECGD (and being prevented from doing so under its agreement with ECGD), GEFCO is held, for the purposes of national accounts, to be a separate organisation to ECGD. As a result, its accounts are not consolidated with those of ECGD.

14. The above arrangements raise a number of concerns over the extent to which ECGD's

accounts accurately reflect its actual and potential costs to the taxpayer:

- **Contrary to assurances that ECGD covers its administrative expenses from its premium income, as required by EU law and the WTO, it would appear that the entire cost of administering the FREF refinancing scheme is recovered from GEFCO's Treasury loans**. Under its arrangement with ECGD, GEFCO deducts its administrative expenses and fees (totalling £711,000 in 2010-11, but previously as much as £2.8 million) from the principal and interest payments made by GEFCO to ECGD on its Treasury loans. The outcome has been not only to provide a hidden subsidy to FREF customers (in that the true costs of operating the FREF scheme are not reflected in the premiums charged), but also to give a false picture of the extent to which ECGD covers its costs from its premium income.

- **Because GEFCO's accounts are not consolidated with those of ECGD, the Treasury loans that pass through ECGD/UKEF to GEFCO are booked in ECGD's accounts as assets rather than liabilities, despite ECGD guaranteeing all of GEFCO's liabilities**. GEFCO's total liabilities currently stand at £262,714,000, but, at their height, amounted to £2.6 billion. Were these liabilities accurately to be reflected in ECGD's books, the premiums charged by ECGD to customers might arguably have been higher in order to meet the Treasury's requirement that ECGD price its premiums to cover expected and unexpected losses. In effect, **by placing these liabilities off-balance sheet, the arrangement with GEFCO may have artificially reduced premiums, thus constituting an illegal subsidy**.

- **Although ECGD/UKEF's accounts now acknowledge that ECGD has undertaken to guarantee GEFCO (until 2006/07, no such acknowledgment was included), the full extent of the guarantee is not disclosed**. ECGD/UKEF omits, for example, any mention of guaranteeing the refinancing loans made to GEFCO by the Treasury. Instead, the accounts acknowledge only responsibility for GEFCO's overdraft with Lloyds bank, its bond issues and its cross currency swaps. **The true extent of ECGD/UKEF's liabilities would thus appear to be unstated**.

- **The arrangement appears to obscure the full extent of ECGD/UKEF's FREF losses**. When a refinanced loan goes into default, the default is covered by an additional loan to GEFCO from ECGD. This additional loan does not appear to be accounted for separately by either GEFCO or ECGD, but is lumped in with other borrowings received. As a result, it is difficult to assess how much of the money voted to ECGD for GEFCO is for refinancing and how much for writing off bad debt. The full extent of ECGD's losses may thus be hidden, potentially contravening the break-even requirement of the WTO's Agreement on Subsidies and Countervailing Measure by distorting ECGD's (true) losses.

- **ECGD's operation of FREF was arguably in breach of the EU's state aid rules, in that the FREF scheme constituted an acknowledged subsidy to those companies that received interest rate support from ECGD.**

15. **The Corner House believes that the extent of subsidy involved in ECGD's operations may have been substantially underestimated as a result of its use of GEFCO, and that this should be investigated as a matter of priority. An informed view of the extent of ECGD's support for UK exporters and its effectiveness requires that such subsidies are transparent and not hidden through off-balance sheet vehicles such as GEFCO**.

ECGD/UKEF's HUMAN RIGHTS OBLIGATIONS UNDER THE LISBON TREATY

16. The current Danish Presidency of the European Council of Ministers has recently confirmed that all European Union export credit agencies are legally bound by the "External Action Provisions" of the Treaty of Lisbon.

17. These provisions are set out in Title 1 ("Common Provision") Articles 3 (5) and Title V, Chapter 1 ("GENERAL PROVISIONS ON THE UNION'S EXTERNAL ACTION") Article 21 of the Treaty.

18. Title I ("Common Provision") Articles 3 (5) requires that:

    "*In its relations with the wider world, the Union shall uphold and promote its values and interests and contribute to the protection of its citizens. It shall contribute to peace, security, the sustainable development of the Earth, solidarity and mutual respect among peoples, free and fair trade, eradication of poverty and the protection of human rights, in particular the rights of the child, as well as to the strict observance and the development of international law, including respect for the principles of the United Nations Charter*."[10]

19. Title V, Chapter 1 Article 21 requires, inter alia, that:

    "*The Union's action on the international scene shall be guided by the principles which have inspired its own creation, development and enlargement, and which it seeks to advance in the wider world: democracy, the rule of law, the universality and indivisibility of human rights and fundamental freedoms, respect for human dignity, the principles of equality and solidarity, and respect for the principles of the United Nations Charter and international law*."[11]

20. These legally-binding obligations are also reflected in the recently approved EU Regulation that transposes the OECD Arrangement on Export Credits into EU law. The Preamble states:

    "*The Member States should comply with the Union's general provisions on external action, such as consolidating democracy, respect for human rights and policy coherence for development, and the fight against climate change, when establishing, developing and implementing their national export credit systems and when carrying out their supervision of officially supported export credit activities*."[12]

21. Despite these legally-binding obligations, ECGD/UKEF has not put in place measures and procedures that would enable it to comply with the EU's External Action Provisions. On the contrary, its decision in 2011 to abandon its previous Business Principles and to exempt applications under £10 million in value or with repayment terms of less than two years from mandatory environmental and social assessment means that it is moving away from compliance with the EU *acquis*, not closer to it.

22. Moreover, the procedures under which ECGD/UKEF currently assesses applications – namely, the OECD Common Approaches on Environment and Officially Supported Export Credits – are entirely inadequate for assessing compliance with EU objectives (the intention of the Article 21), not least because they give no consideration to compliance with international human rights obligations.

23. The Corner House believes that ECGD/UKEF must introduce mandatory human rights assessments if it is to ensure that it meets its obligations under Article 21. These assessments should be tailored to assessing compliance with the UN Charter and international human rights norms.

24. Under recently introduced EU law, ECGD/UKEF, in common with other EU export credit agencies, is now obliged to report to the European Commission every year on its compliance with EU objectives and obligations. The Corner House would urge the APPG to monitor closely ECGD/UKEF's response.

The Corner House

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1 ECGD, "Written Evidence", The impact of UK overseas aid on environmental protection and climate change adaptation and mitigation - Environmental Audit Committee, 27 January 2011, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmenvaud/710/710vw17.htm

2. "Regulation (EU) No 1233/2011 of the European Parliament and of the Council of 16 November 2011 on the application of certain guidelines in the field of officially supported export credits and repealing Council Decisions 2001/76/EC and 2001/77/EC", http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0045:01:EN:HTML

3 Hansard, HC Deb, 17 May 2012, c330W, http://www.theyworkforyou.com/wrans/?id=2012-05-17a.106919.h

4 UK Treasury, "End of Year Fiscal Report", December 2005, p.33, para 4.39, http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/pbr05_endofyear_296.pdf

5 See: "The Future of ECGD", Treasury briefing for Non-Governmental Organisation, 2004.

6 NERA Economic Consulting, "Estimating the Economic Costs and Benefits of ECGD: A Report for the Export Credits Guarantee Department", January 2003, p.35, http://www.nera.com/extImage/5918.pdf

7 ECGD, *Annual Report and Trading Accounts*, 1997/98, p 38.

8 Rt Hon Vince Cable MP, Secretary of State for Business, Innovation and Skills, Oral evidence to Business, Innovation and Skills Select , Wed, 27 April 2011, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmbis/c945-i/c94501.htm

9 GEFCO, "Report of the Directors and Financial Statements for the Year Ended 31 March 2009", p.19.

10 European Union, Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, March 2010, p.17, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:FULL:EN:PDF

11 European Union, Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, March 2010, p.17, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:FULL:EN:PDF

12 "Regulation (EU) No 1233/2011 of the European Parliament and of the Council of 16 November 2011 on the application of certain guidelines in the field of officially supported export credits and repealing Council Decisions 2001/76/EC and 2001/77/EC", http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:326:0045:01:EN:HTML