

Estimating the economic cost of ECGD

The Export Credits Guarantee Department (ECGD) is the UK's official Export Credit Agency, with a mission to benefit the UK economy by providing insurance and guarantees to exporters. [As announced by the Secretary of State for Trade and Industry on 1 July 2004](#), ECGD will be piloted as a capitalised Trading Fund from April 2005, with the intent of introducing a statutory Trading Fund from April 2007.

ECGD is mandated to break-even. A private sector insurer or lender would have to earn sufficient profits to remunerate the capital that its investors had provided, commensurate with the risks it was taking onto its portfolio. Mandating ECAs to break even, rather than to generate profits and thus remunerate capital, carries an economic cost for governments. This can be expressed as the *opportunity cost* of investing cash in an ECA rather than investing in financial assets that have a similar risk of loss but which yield higher returns.

As part of ECGD's move to Trading Fund status, the Government has committed itself to continue to provide export credit on a break even basis. Ministers required that the economic cost of this commitment be estimated and reported on a transparent basis, consistent with the approach taken for other industrial support policies. **The UK Government has estimated the annual economic cost of ECGD support to be approximately £150 million.** From the planned inception of the statutory ECGD Trading Fund in 2007, this economic cost will be incorporated into the budget of the Department of Trade and Industry. For the first time anywhere in the world, Government and public have a transparent assessment of the economic cost of providing export credit on a break even basis, and will be able to compare this cost with other forms of industrial support. The Government is also encouraging other countries to examine the economic cost of their own ECAs.

This note describes the proposed method used for estimating ECGD's economic cost, including all inputs and assumptions. Given the nature of ECGD's business, it is difficult for any method to capture with precision the potential volatility and economic costs of ECGD's business and we will continue to review the appropriateness of this draft methodology. Equally, to the extent that the assumptions we have used do not fully reflect the complexity of ECGD's business, the estimate of economic cost they produce may also be imprecise. [We would welcome comments and questions about the approach taken](#), which will be taken into account when this methodology is reviewed as part of the 2006 Spending Review.

Key features of the method

The UK has estimated the economic cost of its ECA using the principles of Capital Markets Pricing Comparison (CMPC) methodology, comparing ECGD's premia with imputed market prices.

If ECAs operated in a competitive market, the price paid for a guarantee would approximate to the advantage accruing to the borrower under the guaranteed loan. This advantage is the difference between the price those borrowers would have to pay on a loan without a guarantee, and the price they pay with a guarantee. ECAs do not charge

competitive market prices (ECGD is charged to complement not compete with the private market and the market may not be prepared to provide ECA-type products for exports to high risk countries at any price). Instead ECAs price to break even in cash terms, so the premium paid is lower than the imputed market price. **The difference between the imputed market price of the guarantee and the actual premium paid to ECGD is the economic cost to Government.**

To take a very simple example, if the UK 1-year gilt rate (the cost to the UK Government of borrowing) is 4% per annum, and ECGD guarantees a £200 million loan for one year to a foreign buyer in a country where the spread (the cost to the foreign government of borrowing sterling) is assumed to be 9% per annum over UK gilts, in return for premium income of £6 million, the customer benefit of that guarantee is:

$$((9\%-4\%)*£200m)-£6m = £4m$$

In this simple example, the ECGD guarantee has reduced the cost of borrowing to the overseas buyer by £4 million, by transferring this opportunity cost to the UK Government.

This method is then applied to a typical annual portfolio of ECGD new business to estimate the economic cost of all new business underwritten in a single year¹, to arrive at an annual economic cost figure. This cost is incurred when business is underwritten ie the point when ECGD commits itself to the future transfer of benefits to overseas buyers – in other words, if no new business were conducted the annual economic cost would fall immediately to zero.

Costs not included in the calculation

The method has been applied to ECGD's main activity – the provision of credit guarantees – and has excluded other operations that also give benefits to customers and potential costs to government. For practical reasons, the costs of these other activities have not been estimated. They include economic costs arising from ECGD's non-underwriting business, such as Fixed Rate Export Finance (FREF), the cost of ECGD business for which this methodology is not suitable, and the cost of pre-credit, a free option where for a limited period ECAs offer overseas buyers the opportunity, but not the obligation, to enter into a loan agreement.

Inputs

The [accompanying spreadsheet](#) applies the method, modelling the economic cost with the following assumed inputs:

Overseas buyer borrowing rate with ECGD guarantee

- With an ECGD guarantee the overseas buyer will be able to borrow at a small margin above gilts. The estimate sets this margin at 1%, by comparing the current gilts rate

¹ Rather than looking at the economic cost during the current year of all live policies underwritten in the past.

with the OECD Consensus notification of Commercial Interest Rates (which sets a floor for ECA supported lending).

Average life of guaranteed loans

- The average life of guaranteed loans after taking account of regular planned repayments during the life of a loan is set at 6 years in line with ECGD’s portfolio. For example, for loans of 12 years duration that are repaid through equal annual capital repayments, the average life of each £1 borrowed would be 6 years.

Amount guaranteed during the year

- The value of the loans guaranteed during the year (new business, not the total amount at risk), is set at £2.5 billion in line with recent volumes of business.

Premium income as a percentage of the amount guaranteed

- The annual premium revenue based on the amount of new business underwritten during the year, is set at 3% (premium income of £75m) in line with recent premium income received.

Buyer borrowing rates without an ECGD guarantee

- The method divides ECGD country markets into three categories of risk, low medium or high. “Low Risk” countries have BBB or higher sovereign risk ratings (A or higher for corporate borrowers of asset backed loans), “Medium Risk” countries have BBB- to BB+ sovereign risk ratings (A- or below for corporate borrowers of asset backed loans), and “High Risk” countries covers the remainder of borrowers ie those with sovereign risk ratings below BB+. The new business portfolio has been split across these three categories and an average spread over gilts assigned to each category of borrower (ie the riskier a country, the more an ECGD guarantee reduces the spread over gilts and thus the bigger the benefit to the customer):

Low Risk	40% of the ECGD portfolio	2% spread over gilts
Medium Risk	30% “	4% “
High Risk	10% “	6% “

Approximately 20% of the guarantee portfolio is not amenable to the CMPC approach as appropriate spreads for this subsection of the portfolio are not readily available. FREF costs have also been excluded as they are not part of ECGD’s main credit risk business, and are recorded separately in ECGD’s Annual Report.

The figures used for the gilt spreads are judgements made from looking at a variety of data sources and the movements over a period of time. Current emerging market spreads and corporate bond spreads are at their lowest levels for many years. This is influenced not only by the assessment of the underlying risks but also by global liquidity and alternative investment opportunities. Higher figures have been used to take account of emerging market spreads more typical in the recent past. Other factors may also mean that market bond rates are not a precise guide to the economic cost, such as ECA use of the government-only Paris club to recover debts and the fact that by value about a third of the loans guaranteed by ECGD have physical assets as collateral.

Gilts rate

- The gilt rate is included in the calculation for illustration, but the annual economic cost does not vary with changes in this rate as it is only *the margin above* the gilt rate that determines the cost.²

Discount rate

- The rate at which overseas buyers discount future cash flows to obtain their net present value. The overseas buyer rate is used (the weighted average of the customer borrowing rates as implied by the spreads over gilts) rather than the UK Government rate, as the model aims to derive the future benefit to overseas buyers relative to the price they pay today.

Loan repayments and amount outstanding

- For simplicity, the model assumes that loans are repaid with equal annual instalments beginning at the start of the period and determined by the average loan life; hence the outstanding balance reduces along a straight line to zero at the time of twice the average loan life. The interest rates are applied to this annual outstanding balance.

Net present value of interest reduction

- The reduction in interest paid is calculated for each year, discounted, and then aggregated over all years to obtain the total benefit to overseas buyers.

Applying these assumed inputs (see the accompanying spreadsheet) produces an economic cost of approximately £150 million. The Government will keep this method and inputs under review and will, if necessary, produce an updated methodology as part of the 2006 Spending Review. The final economic cost number will be estimated during Budget 2007 ahead of ECGD's intended move to statutory Trading Fund status on 1 April 2007, when the economic cost figure will be incorporated into the Department of Trade and Industry budget.

**SECRETARY OF STATE FOR TRADE AND INDUSTRY
CHIEF SECRETARY TO THE TREASURY
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² There is a small impact from a change in the gilt rate since it is in the calculation of the discount rate used to obtain the net present value of future benefits.