



**EXPORT CREDITS GUARANTEE DEPARTMENT**

**CONSULTATION ON ECGD SUPPORT FOR  
FIXED RATE EXPORT FINANCE**

## WHY IS ECGD CONDUCTING THIS CONSULTATION?

The Export Credits Guarantee Department (“**ECGD**”) is undertaking a review of its provision of support for Fixed Rate Export Finance (“**FREF**”). This Public Consultation is being carried out as part of that review.

ECGD’s current FREF scheme (“**2005 FREF**”) is due to expire on 31 March 2008. In her July 2004 Statement to Parliament on the future of ECGD, the then Secretary of State for Trade and Industry, Patricia Hewitt, announced that ECGD would review the future of FREF prior to the expiry of the existing scheme.

The objectives of this Consultation are to:

- Collect evidence on which to base ECGD’s decision on the future of FREF; and
- Canvass the views of interested parties on the impact of possible changes to ECGD’s FREF policy.

The Minister of State responsible for ECGD has agreed to a shortened consultation period of eight weeks in view of the limited number of interested parties likely to be affected by any policy changes in relation to FREF and the prior knowledge many of these parties have had of the impending review from earlier public announcements.

**Issued** 5 December 2007

**Respond by** 30 January 2008

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## EXECUTIVE SUMMARY

- 1 The Export Credits Guarantee Department (“**ECGD**”) is undertaking a review of its provision of support for Fixed Rate Export Finance (“**FREF**”) as its current FREF scheme (“**2005 FREF**”) expires on 31 March 2008. This Public Consultation is being carried out as part of that review.
- 2 Historically, FREF has played an important role in supporting UK exports. However, over the last ten years, the proportion of new business for which ECGD provides FREF support has decreased significantly, with a corresponding increase in the proportion of new ECGD business which is financed at commercial rates of interest.
- 3 ECGD’s review of the FREF scheme is being conducted against the background of a Public Consultation on Simplifying Business Support undertaken recently by the Department for Business, Enterprise and Regulatory Reform (“**BERR**”) <sup>1</sup>. In its initial response to that Public Consultation, the Government indicated that its decisions on future business support for a particular product would be based on that product’s economic rationale, its likely effectiveness and the business need.
- 4 ECGD is, therefore, seeking the views of relevant interested parties in order to inform its review of FREF.
- 5 The main objectives of this Public Consultation are to:
  - 5.1 Collect evidence on which to base ECGD’s decision on the future of FREF; and
  - 5.2 Canvass the views of interested parties on the impact of possible changes to ECGD’s FREF policy.
- 6 Options under consideration for the future of FREF support are:
  - 6.1 Option 1: Discontinuing the provision of FREF support after 31 March 2008.
  - 6.2 Option 2: Continuing FREF support for a further period, within an appropriate regime of financial objectives and budgetary parameters to contain its cost.
- 7 If ECGD were to follow Option 2, consideration would be given to reducing the level of the margins paid to the banks for providing FREF loans. This would be the subject of separate discussions with the British Bankers’ Association.
- 8 The consultation questions are:

In relation to Option 1:

**(1) Do you think that ECGD should continue to offer FREF support after 2005 FREF expires on 31 March 2008?**

**(2) What is your view of the likely effect of discontinuing FREF support?**

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<sup>1</sup> See [www.berr.gov.uk](http://www.berr.gov.uk)

In relation to Option 2:

**(3) Would you propose any amendments to 2005 FREF with a view to improving its effectiveness?**

Please provide the reasoning behind, and evidence in support of, your response to each of the above questions.

- 9 In order to assist you in making an informed response, paragraphs 23 to 81 of this consultation document contain information regarding the history and mechanics of FREF, its international context and economic rationale, and the arguments in favour of each of the options set out in paragraph 6 above. You should read those paragraphs before formulating your response.

## HOW TO RESPOND

10 This Consultation opens on 5 December 2007. The final date for receipt of responses is 30 January 2008.

11 When responding, please state whether you are responding as an individual, on behalf of a company or representing the views of the members of an organisation. If responding on behalf of an organisation, please make it clear who is represented by the organisation and, where applicable, how the views of members were compiled.

12 A response can be submitted by letter, fax or email to:

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13 A list of those organisations and individuals who will receive a copy of this consultation document is set out in Annex A.

### Additional copies

14 You may make copies of this consultation document without seeking ECGD's permission. Further printed copies of this consultation document can be obtained from:

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An electronic version can be found at [www.ecgd.gov.uk](http://www.ecgd.gov.uk).

15 Versions of this document in Braille, other languages or on audio-cassette can be provided on request, as appropriate.

## Confidentiality & Data Protection

16 All information contained in your response, including personal information, may be subject to publication or disclosure pursuant to the Freedom of Information Act (2000). In any event, ECGD intends to publish all responses which it receives unless (a) confidentiality is requested, and (b) it would be consistent with the Freedom of Information Act (2000) for ECGD to keep such responses confidential.

## Impact Assessment

17 Attached to this consultation document at Annex D is the draft Impact Assessment (the “**Draft IA**”). This document sets out what ECGD believes to be the impact of possible changes to ECGD’s policy on support for FREF, based on the options outlined in the consultation document.

18 ECGD seeks comments from consultees on its Draft IA. ECGD would also welcome comments on any unintended consequences or other impacts not currently contained in the Draft IA that you might identify. The final Impact Assessment which will be included in the Government’s response will take account of the responses received from consultees.

## Consultation Criteria

19 A copy of the Government’s Code of Practice on Consultation can be found at <http://bre.berr.gov.uk/regulation/documents/consultation/pdf/code.pdf>.

20 In its consultation exercises, ECGD aims to follow that Code of Practice and, in particular, to:

- 20.1 Consult widely throughout the process, allowing a minimum of 12 weeks<sup>2</sup> for written consultation at least once during the development of the policy.
- 20.2 Be clear about what ECGD’s proposals are, who may be affected, what questions are being asked and the timescale for responses.
- 20.3 Ensure that this consultation is clear, concise and widely accessible.
- 20.4 Give feedback regarding the responses received and how the consultation process influenced the policy.
- 20.5 Monitor ECGD’s effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- 20.6 Ensure that this consultation follows better regulation best practice, including carrying out an Impact Assessment if appropriate.

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<sup>2</sup> Note that, in this particular instance, a shortened consultation period of 8 weeks has been agreed by the Minister responsible for ECGD. See ‘Why is ECGD Conducting this Consultation?’

## **Help with queries**

21 Questions about the policy issues raised in the document can be addressed to:

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22 If you have comments or complaints about the way this consultation has been conducted, these should be sent to:

**Steve Roberts-Mee**  
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## BACKGROUND

### ECGD

23 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.

24 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.

### What is FREF?

25 ECGD's FREF scheme enables UK exporters to offer medium and long term finance to their overseas buyers at officially supported fixed rates of interest. Such official financing support is provided by a number of governments or ECAs pursuant to the OECD Arrangement on Officially Supported Export Credits (the "**OECD Arrangement**"). The minimum fixed interest rates which may be supported under the OECD Arrangement in this manner are called Commercial Interest Reference Rates ("**CIRRs**").

26 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 based on the appropriate CIRR. If, at the end of any interest period, that fixed rate of interest is below the floating rate paid by the bank for its funds, ECGD makes a payment to the lending bank equal to the difference between (a) the amount of floating rate interest that the bank pays on its funding plus a margin which it receives on the amount of principal outstanding under the loan during that interest period, and (b) the fixed rate interest payable by the borrower. Conversely, if, at the end of any interest period, the aggregate of the amount of floating rate interest plus the bank's margin is below the amount of fixed rate interest, the bank makes a corresponding payment to ECGD. These payments are also known as Interest Make-Up ("**IMU**") payments. The flow of these payments is shown in [Figure 1](#) below.

27 The margin which the lending bank receives under a FREF loan (the "**FREF Margin**") represents the bank's remuneration for its provision and administration of the loan. It is payable on each date when periodic interest is due under the loan and is a percentage of the amount of principal outstanding on that date.

28 The IMU arrangements between ECGD and the lending bank expose ECGD to interest rate risk. ECGD manages this risk by hedging it in the interest rate swap market (see paragraph 41 below).

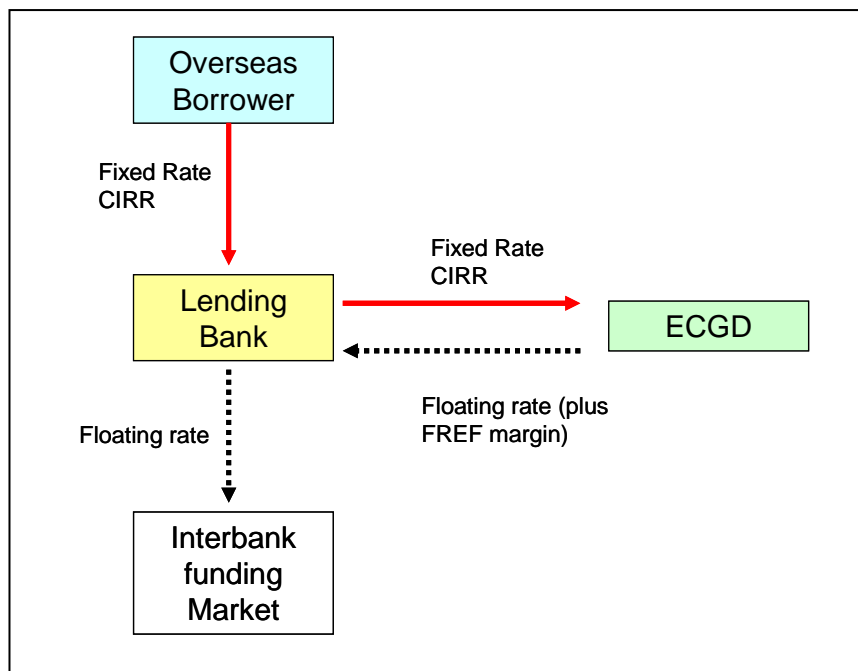


Figure 1: IMU Arrangements under the FREF scheme

### Why is ECGD reviewing its support for FREF?

29 2005 FREF is due to expire on 31 March 2008. In her July 2004 Ministerial statement to Parliament on the future of ECGD, the then Secretary of State for Trade and Industry announced that ECGD would review 2005 FREF prior to its expiry in the light of experience and of progress internationally in reforming the CIRR regime.

30 ECGD has now offered 2005 FREF over a period of time sufficient to enable it to evaluate its experience in operating the scheme and in pursuing its international CIRR reform agenda. In order that any policy decisions on the future of FREF are informed by the views of external interested parties, ECGD wishes to consult interested parties, inviting them to provide their views and supporting evidence.

31 ECGD's current review of FREF is also being conducted against the background of the Public Consultation on Simplifying Business Support undertaken by BERR. The 2005 FREF scheme was excluded from that consultation on the ground that it was subject to its own separate review. In its initial response to that Consultation, the Government indicated that its decisions on future business support would be based on a product's economic rationale, its likely effectiveness and the business need.

### International Regulations

32 The OECD Arrangement stipulates how CIRRs are determined for individual currencies and loan maturities. CIRRs are the minimum interest rates which can be applied to a fixed rate loan when official financing support is being provided by an ECA. The OECD Arrangement also specifies the maximum period for which a particular CIRR can be held. CIRRs are calculated monthly for most of the main trading currencies.

- 33 The Sector Understanding on Export Credits for Civil Aircraft (the “**ASU**”) is part of the OECD Arrangement and deals specifically with issues in relation to officially supported export credits for civil aircraft. The ASU states that the standard form of official support for large civil aircraft is by way of Pure Cover. However, in exceptional circumstances, official financing support can be made available on the basis of a CIRR. The ASU has its own CIRRs for all types of civil aircraft, which, whilst not identical to the CIRRs set out in the main body of the OECD Arrangement, are calculated using similar methodologies<sup>3</sup>.
- 34 Notwithstanding the official financing support provisions in the ASU, ECGD’s current policy is not to offer such support for civil aircraft.

## **Evolution of FREF policy**

### *Changes to FREF over time*

- 35 ECGD has had a FREF scheme in one form or another since 1962. Historically, FREF has played an important role in supporting UK exports but, up to the early 1990s, it operated at a significant cost to the Exchequer.
- 36 A review undertaken by ECGD in 1999 of its arrangements for supporting export finance concluded that the ultimate aim should be to abolish FREF, given that the economic rationale for the provision of official financing support was doubtful. However, at the time it was considered that a unilateral withdrawal of FREF by ECGD could put at risk significant export orders unless the private market could provide a viable alternative to FREF.
- 37 ECGD’s 2000 Mission and Status Review<sup>4</sup> stated that ECGD should aim to ensure that UK exporters have access to competitive finance, while progressively reducing FREF costs. Since that time, ECGD has amended the terms of its FREF scheme in an effort to reduce inherent costs, whilst mounting international initiatives to reform official financing support on a multilateral basis.
- 38 There were various revisions to ECGD’s FREF schemes between 1999 and 2005 designed to reduce the cost of FREF to the Exchequer. Notably, there were reductions in FREF Margins, reductions in interest rate holding periods, and the introduction of limits on eligible case sizes. Furthermore, FREF support for large civil aircraft was discontinued after 31 March 2002, with all ECGD support for this sector thereafter being in the form of Pure Cover.
- 39 2005 FREF was introduced on 1 April 2005 and expires on 31 March 2008. Consistent with the Government’s aim to reduce risks and costs inherent in FREF schemes, the terms of 2005 FREF are more restrictive than its predecessors, particularly in relation to interest rate holding periods and eligible case sizes. The terms of 2005 FREF are outlined in Annex B.

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<sup>3</sup> The ASU was amended with effect from 1 July 2007. Transitional arrangements apply until the end of 2010. The new ASU has different arrangements for large (Category 1) and regional (Category 2 and 3) aircraft. More details can be found at: [http://www.olis.oecd.org/olis/2007doc.nsf/linkto/tad-pg\(2007\)4-final](http://www.olis.oecd.org/olis/2007doc.nsf/linkto/tad-pg(2007)4-final)

<sup>4</sup> See [www.ecgd.gov.uk](http://www.ecgd.gov.uk)

## International Policy

40 Internationally, most ECAs (or related financial institutions) still offer government-backed interest rate support in one form or another. The Government has pressed for reform of the current CIRR regime with a view to aligning it better with commercial market practices. ECGD and HM Treasury have looked to obtain support for this objective within the EU so that the EU can promote reform within the OECD.

## Hedging Policy

41 With the aim of achieving certainty of financial outturn for the various FREF schemes, ECGD has progressively adopted a policy of active hedging of the interest rate risks to which it is exposed through supporting FREF. As ECGD is not permitted by HM Treasury to take a view on the future direction of interest rates, it seeks to hedge to the fullest extent possible, and at the earliest opportunity, the interest rate risk arising from any new FREF transaction.

## ECGD's Experience in running the FREF scheme

42 Figure 2 below shows the value of new guarantees issued by ECGD under Pure Cover<sup>5</sup> and under FREF for each of the financial years since 1991<sup>6</sup>. (The 2007-8 financial year includes data to end-October 2007).

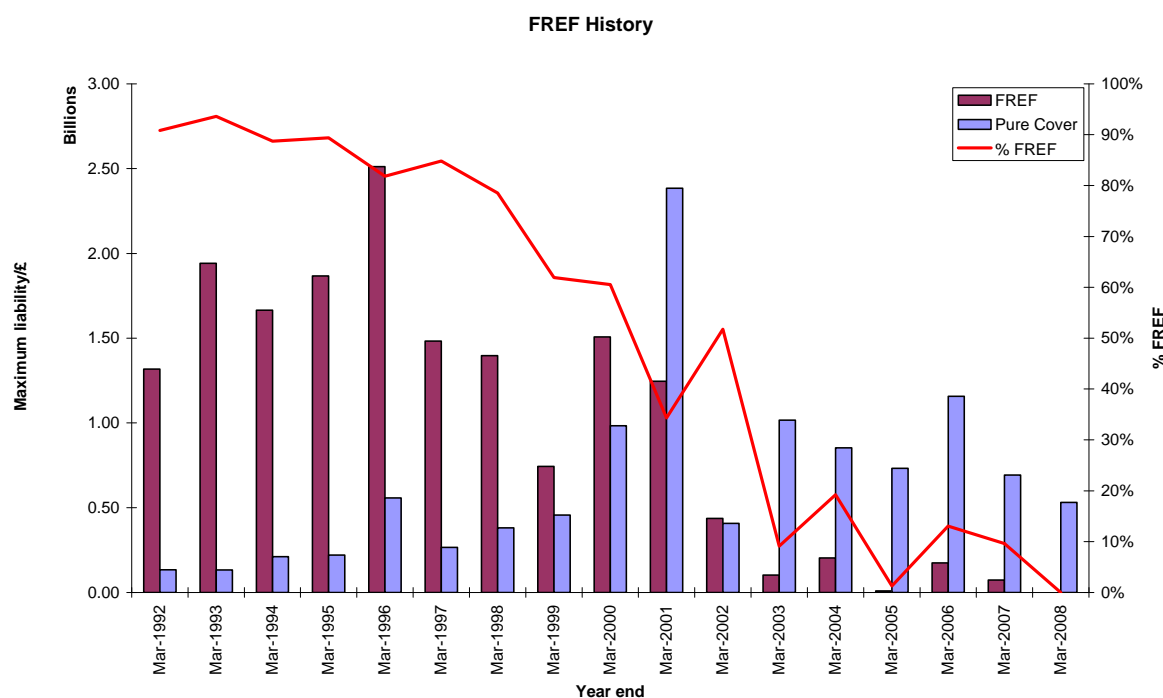


Figure 2: Values of ECGD guarantees issued under Pure Cover and under FREF since 1991 and the percentage of the combined total which is attributable to FREF.

43 The utilisation of FREF support has diminished considerably since 1991, when some 90% of new guarantees (by value)<sup>7</sup> were financed through FREF. By the

<sup>5</sup> These figures exclude ECGD support provided in the form of insurance.

<sup>6</sup> In order to permit comparisons to be made with earlier years, business levels are expressed in Maximum Liability terms (i.e. inclusive of interest over the life of the loan).

time of the 1999 review, the proportion of new guarantees containing FREF support had fallen to 60% of the total guarantees issued, with Pure Cover finance rising to 40%.

- 44 In 2002-3 (i.e. the first financial year for which there was no FREF support for civil aerospace business), the utilisation of FREF support compared to Pure Cover support dropped sharply to around 10%. Since that time, the value of new guarantees containing FREF support provisions has averaged 9% per of the total annual value of new guarantees issued. As is evident from [Figure 2](#) above, ECGD's overall new business levels have also reduced significantly over the last seven years.
- 45 Between 1 April 2005 and 31 October 2007, loans supported by ECGD under 2005 FREF amounted to £87m in aggregate<sup>8</sup> against a total of £1.8bn of new guarantees issued. As at 31 October 2007, ECGD had confirmed its willingness to provide support under 2005 FREF in respect of loans totalling a further £50m.
- 46 However, excluding new guarantees in the civil aerospace sector and other new business which does not qualify for 2005 FREF (e.g. loans in excess of £50m), about 35% of the total new guarantees issued since April 2005 that were eligible for 2005 FREF, utilised this support. The remaining 65% was financed at floating rates of interest on a Pure Cover basis.
- 47 Factors typically cited as contributing to the long-term reduction in FREF business volumes are: (a) the ability of the private sector to provide alternative forms of finance as evidenced by the increased demand for Pure Cover, (b) the more restrictive nature of post-2001 FREF schemes, and (c) the overall reduction in levels of business supported by ECGD combined with a declining proportion of that business which is eligible for FREF support.
- 48 In the past, demand for FREF has been linked to trends in interest rates. ECGD has not found a strong relationship between demand for FREF and interest rate movements over the last seven years although this trend cannot necessarily be extrapolated into the future.
- 49 Recently, there has been a trend amongst OECD ECAs towards a higher demand for Pure Cover support. [Figure 3](#) below shows the breakdown of the total amount of export credit support amongst OECD ECAs, by type of cover, between 1998 and 2005 (calendar years).
- 50 Since 2001<sup>9</sup>, due mainly to the increase of support under Pure Cover, there has been a downward trend in the relative amount of CIRR-based support provided via IMU. The percentage of the total amount of IMU support at the end of 2005 compared with the total amount of export credit support was 5% within the OECD and 9% within the EU.<sup>10</sup>

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<sup>7</sup> All percentages in relation to issued guarantees quoted in this consultation document refer to the value of guarantees converted to Sterling.

<sup>8</sup> A total of six guarantees in three markets, all of which were in the civil industry sector (loan value expressed in chargeable loan value terms).

<sup>9</sup> Data from the same source that was used for [Figure 3](#).

<sup>10</sup> This excludes CIRR-based support which may be provided by direct lenders (Direct Credit in [Figure 3](#)) and for which the OECD does not provide disaggregated data.

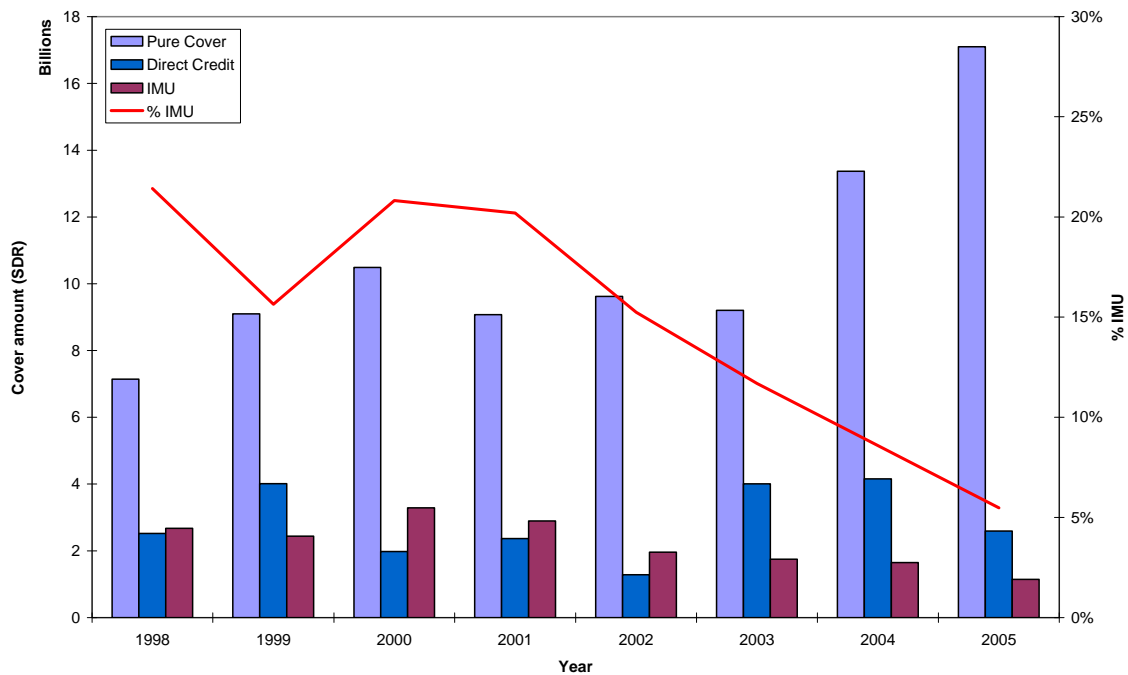


Figure 3: Amounts<sup>11</sup> of official support provided by OECD ECAs for different types of cover. (Source: Statistics on Export Credit Activities (up to and including the year 2005)<sup>12</sup>).

51 Notwithstanding the overall trend for higher levels of Pure Cover support, there is evidence that a small number of borrowers continue to prefer FREF support to Pure Cover alternatives, even in circumstances where the Pure Cover route may provide marginally more competitive interest rates. These borrowers appear to choose FREF because of its international visibility (i.e. the CIRRs are published by the OECD on a monthly basis and are known to all potential borrowers), its lack of complexity, and the confidence derived from the fact that CIRRs are applied by numerous OECD ECAs.

#### *FREF costs*

52 ECGD's FREF costs mainly arise from: (a) the difference between the CIRR and the rate at which ECGD hedges the corresponding interest rate risk, (b) the FREF Margin, (c) ECGD's administration costs, and (d) any costs arising from changes to ECGD's hedging resulting from amendments to FREF loans.

53 FREF costs were high up to the early 1990s. From 1983 until 1993, the annual cost of FREF support on both new and existing FREF business fluctuated between £100m and £400m per annum. FREF costs were subsequently contained due to changes within the OECD and actions taken by ECGD. The progressive introduction of CIRRs<sup>13</sup> (originally seen as "market proxies") within the OECD Arrangement played an important role in cost reduction, as did ECGD's hedging and refinancing programmes coupled with a tightening, over

<sup>11</sup> In SDR (special drawing rights). See <http://www.imf.org/external/np/exr/facts/sdr.htm> for a definition.

<sup>12</sup> 2004 Report on Export Credit Activities with data update for 2005 (TD/ECG(2005)13/FINAL): <http://www.oecd.org/dataoecd/30/35/37931024.pdf>

<sup>13</sup> First introduced in 1983. Standard formula for setting the CIRRs agreed in 1986. Universal application of the CIRRs in 1994.

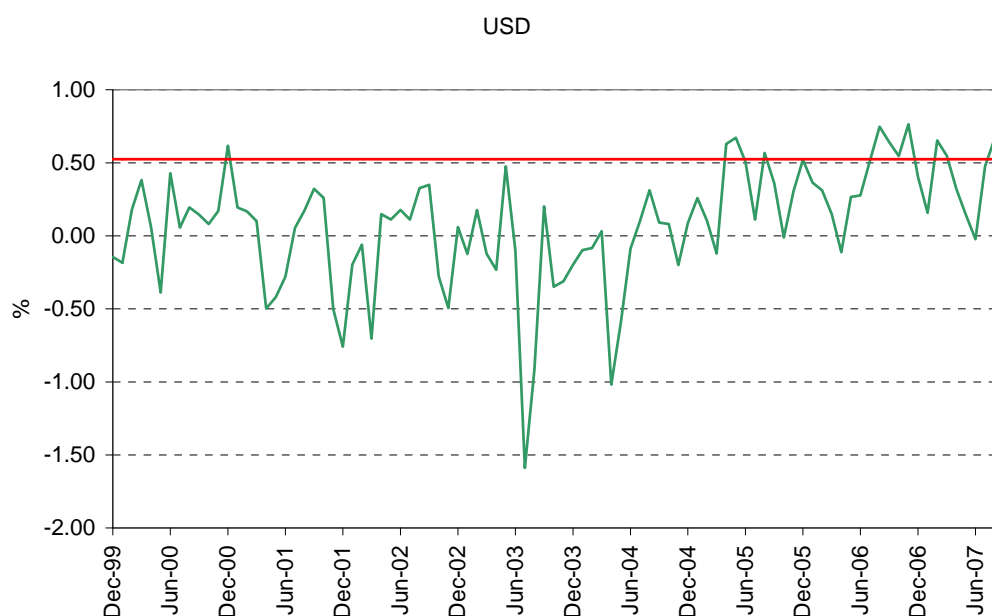
time, of the terms of the FREF scheme and the overall decline in business volumes.

54 ECGD is required by HM Treasury to restrict the costs of operating 2005 FREF over its three year life to a maximum of £30m. The total cost of issued 2005 FREF cases and cases for which ECGD has confirmed its willingness to provide support under 2005 FREF is expected to remain under £1m. This figure is inclusive of all costs referred to in paragraph 52 above.

55 The main reasons for the relatively low cost of the 2005 FREF scheme are: (a) reduced demand (only £87m of loan value supported as at 31 October 2007), and (b) the scheme's reduced flexibility. Nonetheless, there are still elements of inherent cost in 2005 FREF due to the existence of a limited interest rate holding period<sup>14</sup> and to the manner in which the CIRR is constructed. The FREF Margin constitutes another material element of the overall costs of the scheme.

#### *The impact of the FREF Margin on FREF costs*

56 Figure 4 below compares the difference between the CIRR and the corresponding swap rate<sup>15</sup> (on which ECGD's hedging costs are based) for US Dollar ("USD") denominated loans with the typical FREF Margin of 52.5 basis points. USD is the loan currency for which ECGD receives the most enquiries for FREF support. Annex C includes similar comparisons for the other three eligible FREF currencies.



*Figure 4: Difference between the CIRR and a swap rate based on a typical loan with a 3 year drawdown and a 10 year repayment period (green line) as compared to a FREF margin of 52.5bps (red line). Data provided on a monthly basis.*

<sup>14</sup> In essence, between the date the loan agreement is issued to the borrower for signature and the date of actual signature. See Annex B for more details.

<sup>15</sup> The swap rate is the interest rate associated with the fixed portion of an interest rate swap. In this Figure the swap rate has been constructed by ECGD based on the profile of an amortising loan with a 3 year drawdown period and a 10 year repayment period (typical of 2005 FREF cases), using interest rate swap curves obtained from Bloomberg. CIRR rates have been obtained from [www.oecd.org](http://www.oecd.org).

- 57 If the difference between the CIRRR and the swap rate is less than 52.5 basis points, then there is an implied FREF cost. This is because the CIRRR payable by the borrower is insufficient to cover the sum of (a) the cost of hedging the interest rate risk incurred by ECGD, and (b) the cost of remunerating the lending bank through the FREF Margin.
- 58 For all monthly points below the red line, there is an implied FREF cost<sup>16</sup>. This comparison therefore shows that the level of the FREF Margin can be important in determining the overall FREF cost.
- 59 Against the background of a continuously reduced level of inherent FREF costs since 1999, the FREF Margin constitutes an increasing percentage of the overall FREF costs. In the same period ECGD has witnessed a reduction in bank margins under its Pure Cover arrangements. There would appear to be no clear justification in principle for the levels of the margin on FREF-supported loans being significantly out of line with those applicable to Pure Cover loans.

### **How does ECGD's FREF scheme compare with commercially available fixed rate finance under Pure Cover?**

- 60 The CIRRR is based on government bond yields for an appropriate maturity plus a fixed margin of 100 basis points per annum. The maturity chosen depends on the repayment profile of the loan<sup>17</sup>.
- 61 Commercial fixed rate finance provided by banks with the support of an ECGD guarantee is based on swap rates. Lending banks may also apply a margin appropriate for a first class borrower. Unlike CIRRRs, commercially available interest rates will take into account the exact profile of the loan and any interest rate holding period. Banks will also seek to protect themselves against the risk arising from changes in the loan profile after the fixed rate has been agreed.
- 62 Historic CIRRRs for the main four currencies are compared with swap rates<sup>18</sup> in Figure 5 below.
- 63 This comparison indicates that, in general terms, competitive market rates are available to borrowers under ECGD's Pure Cover arrangements. For Sterling, Yen and Euro-denominated loans, CIRRR has been higher than the corresponding swap rate on most occasions, suggesting that over the last 6 years, and purely in terms of the underlying fixed interest rate, the relevant CIRRR has been less competitive than the prevailing commercial fixed interest rates.
- 64 The comparison in Figure 5 below does not take account of any margin which a lending bank might apply to the swap rate under a Pure Cover transaction or any other costs which might arise from the limited holding period.

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<sup>16</sup> In this comparison ECGD has assumed that the CIRRR rate used for FREF support is that applicable at the time when ECGD hedges the interest rate risk arising under the FREF loan. This is mainly ECGD's experience under 2005 FREF.

<sup>17</sup> See [www.oecd.org](http://www.oecd.org) for full details.

<sup>18</sup> ECGD has assumed a standard loan profile with a 3 year drawdown and a 10 year repayment term and that a bank's costs for hedging the interest rate risk in such a Pure Cover case would be based on a swap rate reflecting such an accreting and amortising profile.

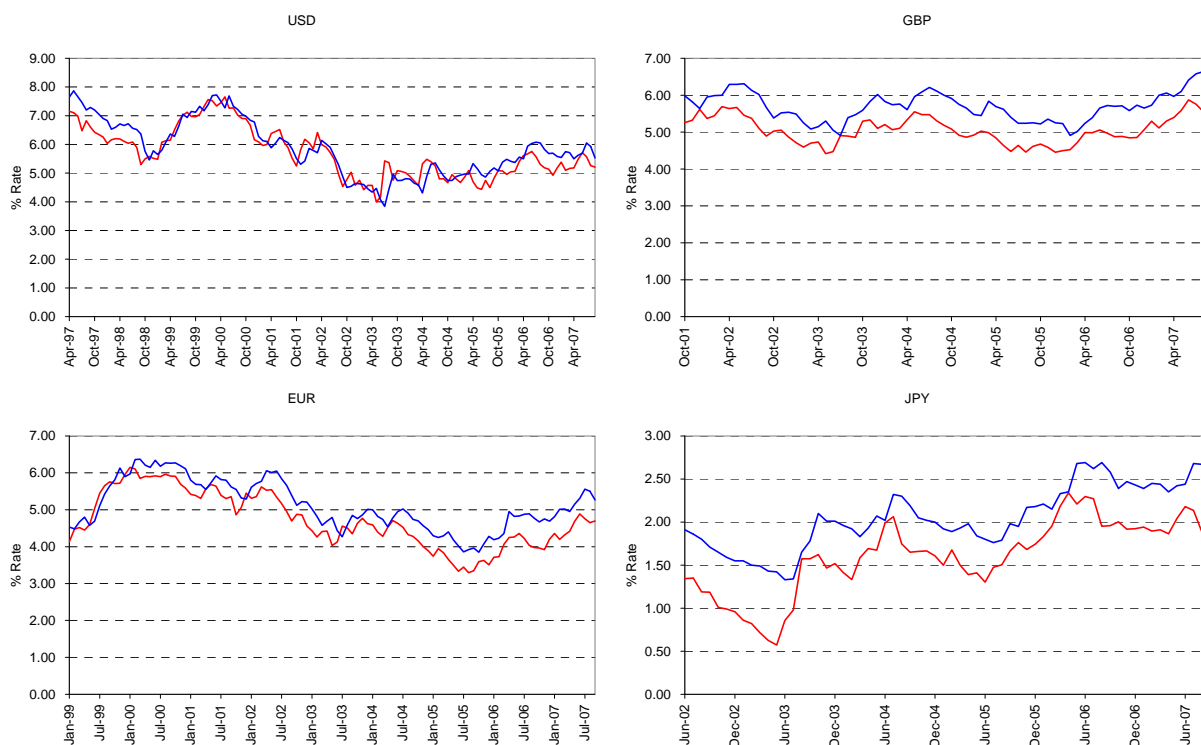


Figure 5: CIRR rate for a loan with a repayment period longer than 8.5 years (blue line) and a swap rate based on a typical loan with a 3 year drawdown and a 10 year repayment period (red line). Data provided on a monthly basis.

### How does FREF compare with similar support provided by other ECAs?

65 A comparison of the CIRR-based support offered by other OECD ECAs with the support offered by the 2005 FREF scheme shows that:

- 65.1 Most OECD countries offer some form of interest rate support, through either a direct lending or an IMU scheme.
- 65.2 Four countries do not offer CIRR financing: Austria, Netherlands, Slovak Republic and Switzerland.
- 65.3 Although the German ECA does not offer an IMU scheme (except for ships), the federal government-backed bank, KfW, is able to offer CIRR finance up to a maximum of EUR700m per annum.
- 65.4 The US Export-Import Bank has the ability to lend at the CIRR, but it has only supported seven cases on this basis over the last five years.
- 65.5 The OECD Arrangement specifies that the maximum interest rate holding period is 120 days. Most countries offer 120-day holding periods for their CIRR as well as pre-contract CIRR<sup>19</sup>. The UK offers a limited holding period<sup>20</sup>; Canada, Germany and Hungary fix the CIRR at loan signature.
- 65.6 Unlike the UK, some of the other providers of CIRR-based finance apply additional charges, e.g. on un-drawn amounts (i.e. Australia,

<sup>19</sup> A CIRR that has been committed prior to the signature of the export contract.

<sup>20</sup> See Annex B for details.

Canada, Germany). Sweden requires that borrowers pay any break funding costs<sup>21</sup> which may result from changes to the loan profile after the loan agreement is signed.

65.7 The UK FREF Margin range is close to the average for the OECD countries.

65.8 The UK has experienced a low demand for FREF support over recent years. This is consistent with a trend for more export support to be provided on Pure Cover terms amongst OECD countries (as shown in [Figure 3](#) above). However, several countries continue to provide a large portion of their export credit support in the form of IMU: the corresponding IMU percentages as compared to the total export credit support provided in 2005 by France, Spain and Poland were 21%, 86% and 65% respectively. Italy did not provide IMU figures for 2005; on 2004 figures its IMU support was 45% of its total export credit support amount.

### **Reform of the CIRR regime – International Progress**

66 One of the Government's objectives has been to reform the current CIRR regime to align it better with commercial market practices. To this end, ECGD, supported by HM Treasury, mounted intensive efforts in the EU between 2003 and 2006.

67 Although ECGD proposals for improving the construction of the CIRR received some support within the EU, a consensus was not reached; accordingly, the ECGD proposals have not been discussed in the OECD. Agreement at both EU and OECD level is required before any change can be implemented.

68 ECGD also proposed that the CIRR should be updated on a fortnightly rather than monthly basis, bringing it closer to prevailing market rates and thus reducing the potential cost to ECAs of having to support a "stale" CIRR. This proposal received support in the EU, but has not been accepted by other OECD countries and consequently has not been implemented. More frequent updating of the CIRR would form part of a package of proposed improvements to current CIRR practices at any future discussions at the OECD.

69 There are several differences in the interpretation of the OECD Arrangement in respect of minimum interest rates and the associated practices. Although it is recognised that work should take place towards harmonising CIRR practices within the EU, obtaining a broader agreement within the OECD is less certain. Progress towards an OECD agreement to change CIRR practices is expected to be very slow.

70 It is, therefore, unlikely that there will be any meaningful progress in the short to medium term in reforming the CIRR regime.

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<sup>21</sup> The cost of modifying hedging arrangements.

## **Is there an economic rationale for ECGD continuing to provide support for FREF?**

- 71 The 1999 ECGD review of FREF concluded that there was a lack of available evidence of market failure and insufficient data to conclude that the provision of FREF support resulted in wider benefits to the UK economy. Even if a market failure were present, it would be necessary to demonstrate that providing FREF support (even in a modified form) is the most cost efficient and effective method for addressing that failure, in order to establish a rationale for the provision of this form of support.
- 72 No new evidence has come to light since 1999 that demonstrates a clear economic rationale for the provision of FREF. There are no identifiable market failures in the provision of fixed rate export financing by the private sector. FREF-supported exports represent an extremely small proportion of the overall value of UK exports; this suggests that the relevance of FREF support to UK firms winning business overseas is very low.
- 73 It is not possible to forecast future demand for FREF support with certainty. As at 31 October 2007, ECGD had confirmed its willingness to provide support under 2005 FREF for loans totalling a further £50m. ECGD has no evidence, therefore, of a significant future increase in demand for FREF support.
- 74 There are market alternatives: international banks have continuously increased their capability and capacity to provide fixed rate finance (as evidenced by the huge growth in the swap and options markets) without ECA support. Although there may be circumstances where Pure Cover at fixed interest rates costs more to the borrower than the provision of finance at the CIRR, this higher cost in itself is not a rationale for government intervention.
- 75 There may be a stronger rationale for providing FREF as a response to schemes offered by other ECAs. This level playing field, or matching intervention, argument could arise where CIRR-based support is crucial to winning export contracts. Where the only basis for providing FREF support is the actions of other ECAs, the optimal policy response would be for the multilateral abolition of all government-backed CIRR schemes.

## THE OPTIONS

76 Two options are briefly outlined below. An analysis of costs and benefits of these options is contained in the Draft IA attached as Annex D.

### 77 Option 1: Discontinuing the provision of FREF support after 31 March 2008

The considerations that may support this option include:

- 77.1 The absence of an underlying economic rationale. In the Government's initial response to the BERR Public Consultation on Simplifying Business Support, the existence of an economic rationale was one of the key selection criteria for the provision of continued government support;
- 77.2 The long-term Government policy of abolishing the scheme; and
- 77.3 The policy objective that ECGD should complement, rather than compete with, the private market given that commercial alternatives to FREF support are now widely available.

This option appears to be further supported by:

- 77.4 The low utilisation of FREF support.

78 In relation to Option 1, ECGD invites responses on the following consultation questions:

**(1) Do you think that ECGD should continue to offer FREF support after 2005 FREF expires on 31 March 2008?**

**(2) What is your view of the likely effect of discontinuing FREF support?**

### 79 Option 2: Continuing FREF support for a further period, within an appropriate regime of financial objectives and budgetary parameters to contain its cost.

The considerations that may support this option include:

- 79.1 Despite a low level of overall use, exports benefiting from FREF still represented 35% of the total value of ECGD new business eligible for FREF support since April 2005;
- 79.2 The current cost of 2005 FREF is less than £1m which is arguably very small relative to the amount of business supported; and
- 79.3 The continuing existence of an "un-level" playing field internationally does not merit unilateral withdrawal of FREF support at a time when other ECAs maintain similar arrangements.

80 In relation to Option 2, ECGD invites responses on the following consultation question:

**(3) Would you propose any amendments to 2005 FREF with a view to improving its effectiveness?**

81 Any future FREF support would continue to be subject to budgetary constraints and financial objectives approved by HM Treasury. These could be different from the 2005 FREF constraints.

## **ANNEX A**

### **List of Consultees**

British Bankers' Association  
British Chambers of Commerce – inc. regional Chambers  
British Chemical Engineering Contractors Association  
British Exporters Association  
Confederation of British Industry  
Engineering Employers Federation  
Federation of Small Businesses  
Institute of Directors  
London Chamber of Commerce  
Society of British Aerospace Companies  
Trades Union Congress

### **Top 10 exporters<sup>22</sup> and exporters who have used 2005 FREF**

Airbus S.A.S  
BAE Systems (Operations) Ltd  
BlueFinger Ltd  
Doncasters Ltd  
Fernau Avionics Ltd  
Invsat Ltd  
Koch Chemical Technology Group Ltd  
Mabey & Johnson Ltd  
MBDA UK Ltd  
Motorola Ltd  
PW Ltd  
Repaircraft Plc  
Rolls-Royce Plc  
Siemens VAI Metals Technologies Ltd  
SMS Mevac UK Ltd  
Thales Training & Simulation Ltd  
VT Shipbuilding International Ltd  
VWS Westgarth Ltd

### **Banks**

Abbey National Plc  
ABN Amro Bank N.V.  
Barclays Bank Plc  
BNP Paribas SA  
Calyon  
Citibank NA  
Deutsche Bank AG  
HSBC Bank Plc  
HBOS Plc  
Lloyds TSB Bank Plc

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<sup>22</sup> By business volumes in the last 12 months. We have also included exporters in respect of business which was either issued under 2005 FREF or for which ECGD has confirmed its willingness to provide support under 2005 FREF.

Mizuho Corporate Bank, Ltd  
The Royal Bank of Scotland Plc  
Société Générale SA  
Standard Chartered Bank

**NGOs**

Campaign Against Arms Trade  
Christian Aid  
Friends of the Earth  
The Corner House  
Transparency International (UK)  
World Wildlife Fund (UK)

## ANNEX B

### ECGD's 2005 FREF scheme

#### 1 Key features of these arrangements are:

- 1.1 Loan Amount: FREF support may only be provided in respect of loans with a value of no more than £50 million for sterling loans, US\$90m for US dollar loans, €70m for Euro loans and ¥10,000m for Yen loans.
- 1.2 Holding period: The fixed interest rate to be supported will be determined on the basis of the CIRR prevailing on or about the date on which the loan agreement is issued by the lender to the borrower for signature, or if ECGD offers to provide a supplier credit facility, the date on which ECGD makes that offer, provided that the loan agreement is signed or the offer is accepted within 30 days (or 60 days in the case of certain types of contract and certain markets as agreed with the British Bankers' Association<sup>23</sup>). Should these events not occur within this period, a new 30-day period will commence and the fixed interest rate applicable to that period will be based on the CIRR prevailing at the start of that new period. The same methodology will be applied to determine the applicable CIRR for any further 30-day periods.
- 1.3 Pre-Contract CIRR: Not available.
- 1.4 The 2005 FREF scheme shall remain in force until 31 March 2008.

#### 2 Under the 2005 FREF scheme, the margins receivable by the lenders shall be no greater than the following:-

<b>Principal value of Loan</b>	<b>Margin (in Basis Points above LIBOR p.a.)</b>
Up to £1m	80.0
Over £1m up to £10m	62.5
Over £10m up to £50m	52.5

<sup>23</sup> These currently being: Mexico, Iran, Brazil, Turkey, Vietnam, Libya and Uzbekistan

## ANNEX C

### Difference between CIRR and a corresponding swap rate

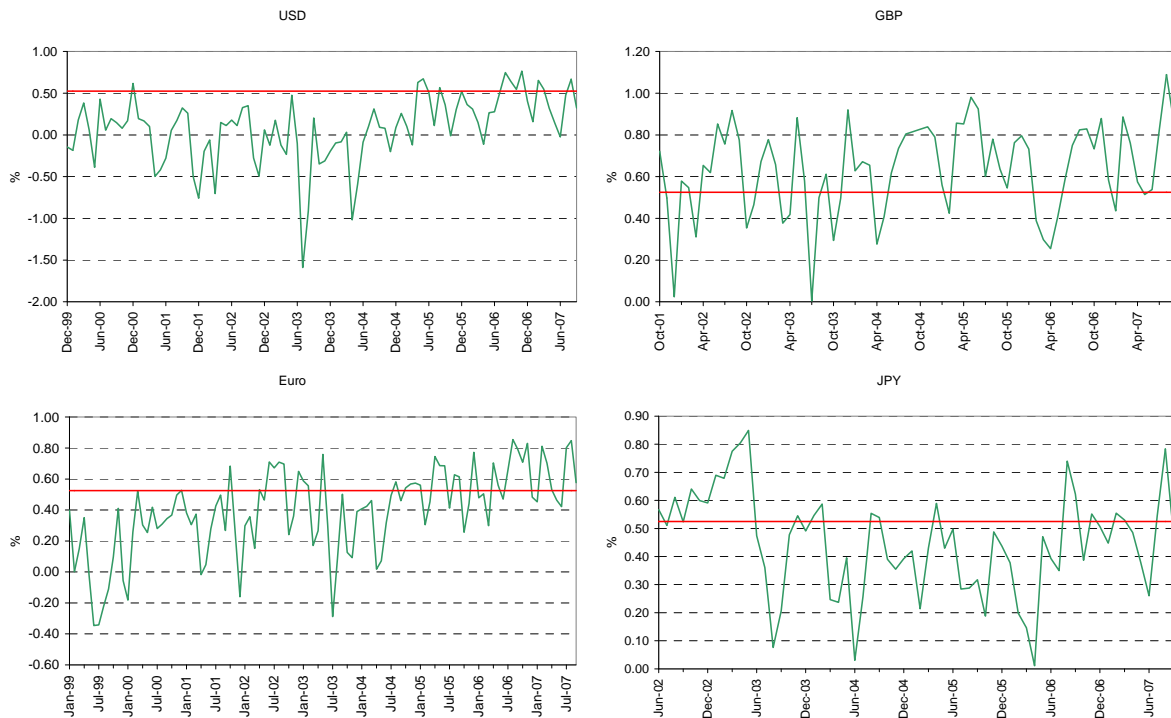


Figure 6: Difference between the CIRR and a swap rate based on a typical loan with a 3 year drawdown and a 10 year repayment period (green line) as compared with the FREF margin of 52.5bps (red line). Data provided on a monthly basis for the four main currencies.

## **ANNEX D**

### **Draft Impact Assessment**

ECGD is inviting comments on its Draft IA which will be finalised after ECGD has received all responses to this Public Consultation.

## Summary: Intervention & Options

<b>Department /Agency:</b> <b>Export Credits Guarantee Department (ECGD)</b>	<b>Title:</b> <b>Impact Assessment of ECGD support for Fixed Rate Export Finance (FREF)</b>	
<b>Stage:</b> Consultation (Draft)	<b>Version:</b> 1.9	<b>Date:</b> 29 November 2007
<b>Related Publications:</b> Consultation on ECGD Support for Fixed Rate Export Finance		

### Available to view or download at:

<http://www.ecgd.gov.uk>

**Contact for enquiries:** Andy Blacksell

**Telephone:** 020 7512 7145

### What is the problem under consideration? Why is government intervention necessary?

ECGD's Fixed Rate Export Finance (FREF) scheme enables UK exporters to offer medium- and long-term finance to their overseas buyers at fixed rates of interest. The necessity for government intervention is not proven. The most plausible justification for intervention is that FREF provides a level playing field internationally and is the UK's optimal response to intervention by foreign governments.

### What are the policy objectives and the intended effects?

The policy objective of the FREF scheme is to ensure that UK exporters have access to competitive medium- to long-term fixed rate export finance.

### What policy options have been considered? Please justify any preferred option.

1. Discontinuing the provision of FREF support after 31 March 2008;
2. Continuing FREF support for a further period, within an appropriate regime of financial objectives and budgetary parameters to contain its cost.

### When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

N/A

### **Ministerial Sign-off** For consultation stage Impact Assessments:

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister:

..... Date:

## Summary: Analysis & Evidence

Policy Option: 1

Description: Discontinue the FREF Scheme

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups'
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	£ N/A	N/A	N/A
	<b>Average Annual Cost</b> (excluding one-off)		<b>Total Cost (PV)</b>
£ N/A		£ N/A	
Other <b>key non-monetised costs</b> by 'main affected groups'			
UK export orders could decline.			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups'
	<b>One-off</b>	<b>Yrs</b>	
	£ N/A	N/A	N/A
	<b>Average Annual Benefit</b>		<b>Total Benefit (PV)</b>
£ N/A		£ N/A	
Other <b>key non-monetised benefits</b> by 'main affected groups'			
ECGD's administrative and financial costs will be reduced. ECGD's operational risks may also decline slightly.			

### Key Assumptions/Sensitivities/Risks

The potential costs assume that FREF results in higher UK exports. The evidence supporting this proposition is anecdotal.

Price Base Year N/A	Time Period Years N/A	<b>Net Benefit Range (NPV)</b> £ N/A	<b>NET BENEFIT (NPV Best estimate)</b> £ N/A
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What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	April 2008			
Which organisation(s) will enforce the policy?	ECGD			
What is the total annual cost of enforcement for these	£ N/A			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£ N/A			
What is the value of changes in greenhouse gas emissions?	£ N/A			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)				(Increase - Decrease)
Increase	£ N/A	Decrease	£ N/A	<b>Net</b> £ N/A

Key: Annual costs and benefits: Constant Prices (Net) Present Value

## Summary: Analysis & Evidence

**Policy Option: 2**

**Description: Maintain the FREF scheme on substantially the same terms for a further finite term**

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups'
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	£ N/A	N/A	As of 31 October 2007, the total cost of ECGD's current FREF scheme (2005 FREF) was £750k. It is estimated that the final cost of 2005 FREF will not exceed £1m.
	<b>Average Annual Cost</b> (excluding one-off)		
£ N/A		<b>Total Cost (PV)</b>	£ N/A
Other <b>key non-monetised costs</b> by 'main affected groups'			
ECGD would continue to be exposed to operational risk.			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups'
	<b>One-off</b>	<b>Yrs</b>	
	£ N/A	N/A	N/A
	<b>Average Annual Benefit</b>		
£ N/A		<b>Total Benefit (PV)</b>	£ N/A
Other <b>key non-monetised benefits</b> by 'main affected groups'			
UK export orders could increase.			

### Key Assumptions/Sensitivities/Risks

The financial costs associated with the FREF scheme are sensitive to future business levels and the interest rate environment.

Price Base Year N/A	Time Period Years N/A	<b>Net Benefit Range (NPV)</b> £ N/A	<b>NET BENEFIT (NPV Best estimate)</b> £ N/A
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What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	April 2008			
Which organisation(s) will enforce the policy?	ECGD			
What is the total annual cost of enforcement for these	£ N/A			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£ N/A			
What is the value of changes in greenhouse gas emissions?	£ N/A			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

**Impact on Admin Burdens Baseline** (2005 Prices) (Increase - Decrease)

Increase    £ N/A                      Decrease    £ N/A                      **Net**                      £ N/A

Key:      Annual costs and benefits: Constant Prices      (Net) Present Value

## Evidence Base (for summary sheets)

### Nature of the Debate

Consideration on whether or not ECGD should continue the FREF scheme can be divided into two logically separate questions: (i) Is Government intervention justified; (ii) if so, do the benefits of FREF outweigh the costs? ECGD has very little quantitative evidence with respect to these questions. Consequently the following is designed to explore the theoretical arguments involved and outline the evidence that is known to ECGD.

### FREF in Context

As noted in the Consultation document, FREF-supported loans amounted to £87m in aggregate between 1 April 2005 and 31 October 2007 FREF. Figure 2 of the Consultation document demonstrates the declining importance of FREF within ECGD's new business volumes. Relative to the total size of ECGD-supported new business, which exceeded £4bn over financial years 2005-07, the volume of business supported under 2005 FREF has not been material. Given 2005 FREF's low volume, its impact on the UK economy has been negligible relative to total UK exports of £233bn in 2006.

### Rationale for Government Intervention

Government intervention is most often justified where markets fail to operate efficiently and government intervention can produce welfare gains. Alternatively, intervention can be justified to promote a more equitable distribution of resources within society. Potential justifications for FREF support focus principally on the concept of failure within the market for fixed rate finance.

#### *Failures in Financial Markets*

■ Traditional sources of market failure include information asymmetries, resulting in moral hazard and adverse selection problems. Further, the small volume of contracts may make the development of effective hedging instruments difficult. These factors, if present, could mean that financial markets fail to provide fixed rate finance efficiently. ECGD is not aware of evidence supporting the existence of relevant market failures. The rapid expansion of fixed rate finance witnessed over the last decade suggests that banks are capable of hedging interest rate risks efficiently and therefore of providing a market-based alternative to FREF. However, the level of margins received by banks providing loans under 2005 FREF may act as a disincentive to private sector provision.

#### *The Role of Other Export Credit Agencies (ECAs)*

■ Although evidence to support government intervention on the basis of traditional market failures is weak, the market is distorted by the provision by other ECAs of finance based on OECD commercial interest reference rates (CIRRs) with associated elements of support. Although the optimal response in a world without market failures would be for all governments to refrain from providing officially supported finance, it does not necessarily follow that any one government would gain from unilaterally ending such official financing support to its own exporters. This is the strongest justification for continuing intervention by ECGD.

### Costs and Benefits

- The policy decision is essentially whether the net benefit of continuing FREF support outweighs the net benefit of discontinuing it.
- Monetised data is available on the historic cost of providing 2005 FREF. More data is available in the 'FREF costs' section of the Consultation document. Between 1 April 2005 and 31 October 2007, the total amount spent by ECGD against the FREF budget, including hedging and administration costs, was £750k. It is estimated that the final cost of 2005 FREF

will not exceed £1m. The future cost of FREF support will depend on business levels and the interest rate environment. It should also be noted that discontinuing the FREF scheme will not result in an instantaneous end to the costs incurred by ECGD, as it is obliged to continue supporting the business already agreed upon under 2005 FREF, and previous schemes. In time, however, these costs would fall to zero. Discontinuing the scheme would also reduce ECGD's exposure to operational risk, although any reduction is likely to be small until all support ceases.

- Weighed against these costs are the scheme's benefits, which are based on whether FREF support results in UK exporters winning additional export orders. The evidence available to ECGD for this proposition is anecdotal. Some banks and exporters have advised ECGD that FREF is in demand in certain markets and that certain sovereign buyers appear to prefer CIRR schemes as a matter of policy. Part of the explanation for this, given that finance at the CIRR is not always preferable to market alternatives, is a lack of interest on the part of buyers to engage in potentially more complex private sector arrangements. As a result, certain exporters have included the availability of 2005 FREF in their marketing to overseas borrowers. The fact that CIRRs are OECD-regulated may give reassurance to such borrowers.
- As previously noted, FREF-supported loans amounted to £87m in aggregate between 1 April 2005 and 31 October 2007. This figure is not easily converted into an assessment of the scheme's benefits, but does provide some indication of their scale. Chief among the difficulties in assessing FREF's benefits is that ECGD has insufficient information to determine whether the contracts supported would have been won without FREF. Furthermore, although any additional contracts won as a result of FREF are likely to be FREF-supported, it is possible that FREF has generated follow on or repeat business that is not picked up in the FREF volumes. Overall, therefore, the value of exports that would be lost if the FREF scheme were discontinued cannot be determined on present information available to ECGD.
- It could be argued that 2005 FREF's influence in winning additional contracts has been very low for two reasons. First, UK exporters' demand for fixed rate finance could be catered for by the private sector, such that the overall impact on exporters would be minimal. Second, 2005 FREF is generally more restrictive than the equivalent schemes of other countries. Consequently, the availability of FREF would be unlikely to be of primary importance to foreign buyers selecting UK exporters. As already noted, there is very little supporting evidence available to ECGD on this issue.

### **Summary of Findings**

- There are no traditional sources of market failure to justify government intervention.
- The provision of FREF-equivalent support by other ECAs distorts the market for fixed rate export finance.
- The private sector is capable of providing a similar product. However, the simplicity of the FREF product may appeal to certain borrowers. Equally, a generous bank margin in IMU arrangements may act as a disincentive to private sector provision.
- Lack of evidence prevents the weighing of costs and benefits against one another. Consequently, this method of analysis cannot be used to determine a preferred policy option.
- Given the low volume of use of 2005 FREF, its impact on the UK economy has been negligible relative to total UK exports of £233bn in 2006.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

It is not believed that this policy will have any impact on race, disability or gender equality.