# Performance

# Chief Executive's report

**Louis Taylor**
Chief Executive Officer

**The government's vision for a Global Britain requires us to be an export credit agency with global reach and ambitions; our Business Plan for 2017-20, published in July after the 2017 General Election, sets out our strategy to achieve this.**

We started the year by announcing support for landmark projects in UAE and Mexico. We ended the year having increased the number of local currencies we can support to 62, from the Panamanian balboa to the Polish zloty.

In between we welcomed new customers for our aerospace business, supporting the UK supply chains for Boeing, GE Aviation, Rolls Royce, Airbus and Bombardier. We grew our partnership with high street banks by introducing streamlined new processes for smaller transactions. We continued to support historically high numbers of companies, including the first ever use of a UKEF product to support companies in export supply chains.

We continued in our commitment to helping the Government of Iraq with post-conflict infrastructure development, supporting the construction and upgrade of several gas-fired power plants with turbines from the UK that will help to alleviate severe energy shortages across the country. We continued to support UK-led construction projects in Dubai, and in Uganda our support will see a Uganda/UK consortium construct the country's second international airport at Kabaale.

Although in headline terms our business issued is lower than last year's at £2.5 billion, our commitments[1] - which reflect activity in the year - are high, at £3 billion, and our pipeline for the year ahead has never been stronger. The number of individual facilities issued remains steady, and in addition to the 191 companies (slightly down from last year) we supported directly or helped to find finance from the private sector, we have connected nearly 400 companies with export opportunities. The number of UK companies we are actively engaged with has also increased, following the Chancellor of the Exchequer's announcement in the Autumn Budget of a specific allocation from the GREAT campaign funding to enhance marketing of UKEF services.

As the UK negotiates its departure from the European Union, we are putting in place measures to support UK exporters through Brexit and beyond, as well as helping them to make the most of new trading relationships. Following the Autumn Statement in 2016, we have this year significantly increased our capacity for over 100 markets, as well as implementing our increased risk appetite limit. Other measures are available should a further increase in capacity be needed. Leaving the EU will not affect the credit-worthiness of our overseas customers, nor the liquidity of the private market, so will not have a fundamental impact on the way we manage our business.

Behind the scenes we continued to invest in our people, systems and processes to become a more scalable organisation, able to support higher volumes of business as required by market conditions and demand and leveraging our position as part of a "One-Department for International Trade" offering to UK business. We have also supported the development of HM Government's Export Strategy, due to be published soon, which will have UKEF at its heart.

We welcomed Shalini Khemka to the UKEF Board, and John Morrison and Roseline Wanjiru to the Export Guarantees Advisory Council. The full composition of our Board is shown on page 74 and membership of the Council is on page 70. The year also saw the retirement of David Havelock CBE; I would like to thank David for his nearly 13 years leading our Credit Risk Group. His expert and judicious approach is evidenced by a period of historically low unrecovered losses, as reported within this report and annual reports past.

1 Commitments are cases not yet the subject of an issued and effective guarantee, but for which UKEF has communicated its intention, before a specified date and subject to conditions, to provide support.

## UKEF's role in the government's Export Strategy

Since supporting our first export in 1919, we have provided finance to trading partners on a simple condition: that they buy proportionately from the UK. Today UKEF remains a valuable source of export finance for international buyers developing infrastructure or making other large investments. This is why we have nearly £30 billion of finance available to support international procurement from the UK, to add to the £23 billion we have already committed.

But while the UK enjoys a reputation for quality and reliability, we realise international buyers don't always understand the depth and breadth of the potential UK supply chain. We also know many of the smaller companies in which they are interested can struggle for visibility in new markets.

The Export Strategy, due to be published later in the year, will set out the Department for International Trade's offer of trade support globally and across the UK, of which UKEF is at the heart. Together, we send a unified and powerful message to overseas buyers: we can help you access high-quality UK companies alongside an attractive finance package that allows you to buy British, pay local, in your own currency and on competitive terms.

Working with regional and event teams across the Department for International Trade and with private sector partners allows us to make this commitment. Whenever we make a finance offer to a buyer, we can offer a comprehensive menu of potential UK suppliers at the same time, not only large lead contractors but companies of all sizes, including hard-to-find specialist suppliers of niche products or services.

To date this commitment has already resulted in five supplier fair events, attended by over 600 UK companies, that are expected to add nearly £2 billion in UK contracts. As the delivery of the Export Strategy gathers pace, we expect the benefits to grow significantly.

## Measuring our success

The volume of business that UKEF supports year-on-year is a measure of private sector liquidity and risk appetite, as much as of our activity and success. We complement, rather than compete with, the financial and insurance support provided from the private sector. If support is available from a commercial bank or insurer, we do not seek to displace this. In many cases, we will work with companies and financial service providers to find a solution from the commercial sector (which we report as a 'private market assist').

Our interventions:

- fill market gaps
- provide additional export value for the UK economy
- support growth in overseas markets for the individual companies that benefit

Our support is provided on the following terms (see pages 48 to 51 for more detail):

- we charge a premium to reflect the risk we assume
- commercial rates of interest are charged on the lending we support, at a rate reflecting UK government risk
- the premium we charge must cover our anticipated long-term losses, as well as our operating costs
- we aim to operate at no net cost to the taxpayer over business cycles

We have reviewed our performance against the key deliverables set out in our 2017-20 business plan. These support our strategic aims:

**Agile and adaptable:** to be an agile department, able to address the challenges to UK exporters throughout the economic cycle.

**Competitive offering:** to be active in ensuring that we are one of the most competitive export credit agencies in the global marketplace.

**Customer service and awareness:** to provide a high-quality service to our customers that is proactive, flexible and efficient with a focus on solutions and innovation.

**Our organisation:** to be a great place to work, where teams work across functions easily and towards common goals.

## Our achievements in 2017-18 against our Business Plan for 2017-20

### Agile and adaptable

| | |
|---|---|
| Digitised workflow capability to process requests for support more quickly and efficiently | **Implemented;** ongoing development |
| A "Team UK" approach: an expression of interest for each relevant High Value Campaign (HVC), so consortia of UK exporters can bid alongside a concrete offer of financing | **Partially implemented** |
| An enhanced approach to risk management following the doubling of risk appetite and market limits | **Implemented;** our risk management is detailed on pages 40 to 59 |

### Competitive offering

| | |
|---|---|
| Widened eligibility for our trade finance products | **Implemented;** ongoing development (see page 31) |
| A refreshed Overseas Investment Insurance product | **Implemented** |
| A wholesale product review to test UKEF's proposition against evolving customer needs | **Initiated and ongoing** |

### Customer service and awareness

| | |
|---|---|
| New partnership with banks to improve access to selected trade finance products | **Implemented;** ongoing development |
| Digital service allowing banks and exporters to apply for short-term products online | **Implemented;** ongoing development |
| 20 finance specialists based in key overseas markets | **Initiated and ongoing** |
| Exploitation of new digital capability to increase the volume and relevance of marketing activity | **Ongoing;** UKEF is now a core GREAT campaign partner |

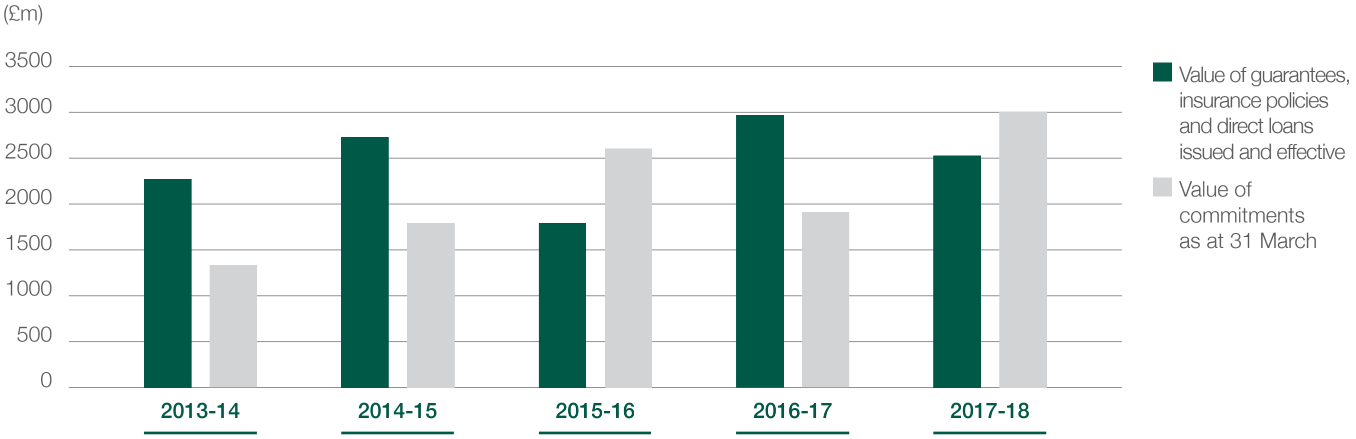
### Great place to work

| | |
|---|---|
| A more flexible approach to deployment of staff resources to match shifting patterns of demand and support effective staff development | **Ongoing;** our people management is detailed on pages 89 to 101 |

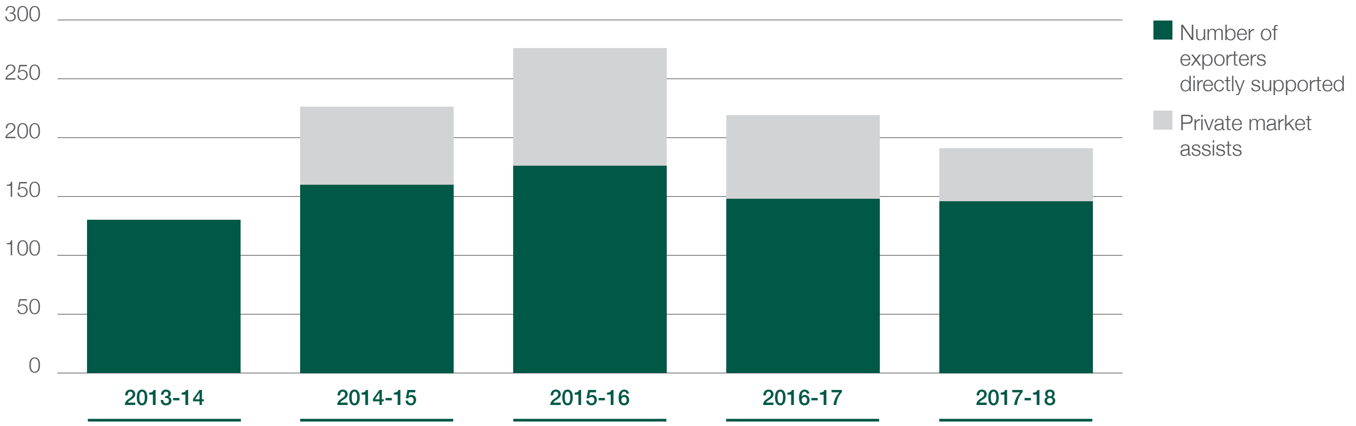
## Businesses supported

We directly supported 191 companies in 2017-18. The maximum liability on all new business was £2.5 billion[2]. Our shorter-term trade finance products supported £466 million of export contracts won by UK businesses.

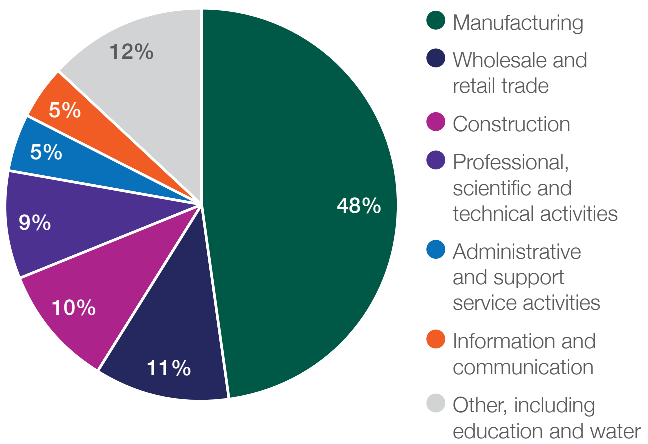
### Value of business issued and committed



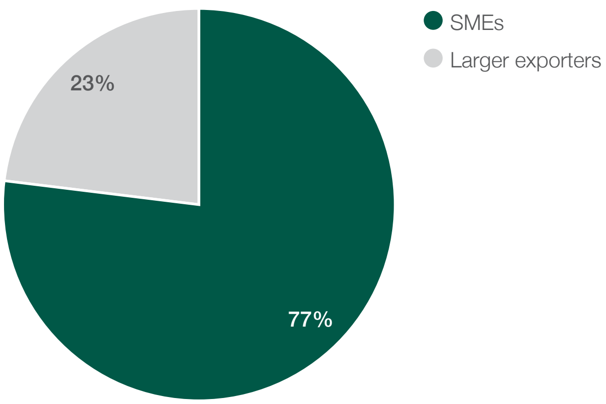

### Number of UK companies directly supported




### Sectors

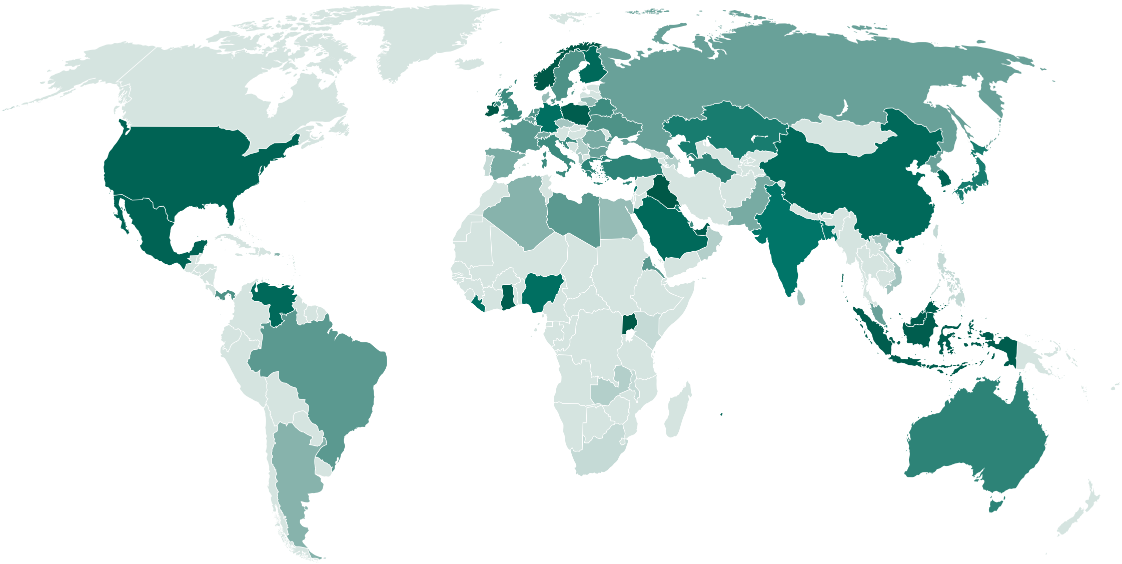



### Company size



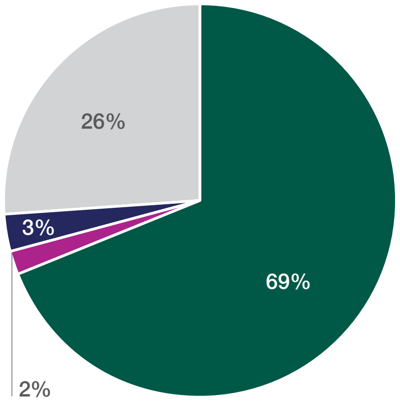

2 This figure shows issued and effective business. It does not include amounts counter-guaranteed or reinsured by another official export credit agency where UKEF was acting as lead ECA on a jointly supported transaction. It does include business supported where the private reinsurance market was subsequently used to offset risk for active portfolio management purposes. It includes £666 million in the form of direct loans and scheduled interest, which is accounted for on a different basis.

## Destination for exports supported in 2017-18

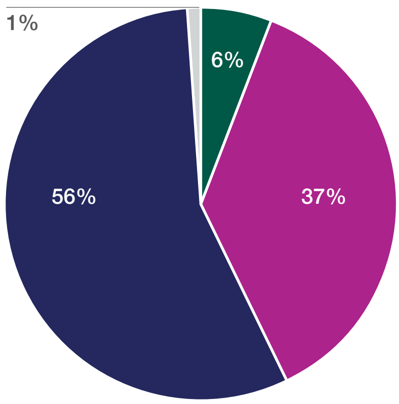


Darker shading indicates higher value of UKEF support

## Product use by our maximum liability




## Product use by number of facilities




- Buyer credit guarantee
- Insurance
- Bond or export working capital support
- Direct loan to buyer

**"UK Export Finance is a part of the Department for International Trade of which I am extremely proud. There are few other countries where businesses are offered such a generous and accessible financial support for their exporting activities."**
**- The Rt Hon Liam Fox MP**
Secretary of State for International Trade and President of the Board of Trade

**"Our new bank partnership is designed with UKEF's smaller customers in mind. We've also made this available to companies that are not themselves exporting, but supplying to exporters, because we recognise the huge contributions of the UK domestic supply chain."**
**- Baroness Fairhead CBE**
Minister of State for Trade and Export Promotion

## Highlights in 2017-18

We were named **best export credit agency** for 2017 by Global Trade Review and Euromoney's Trade Finance

We became a Civil Service high performing department based on our staff engagement survey score, which was in the **top 20%** across government and agencies

We increased by up to **100%** our maximum cover limit for more than 100 individual markets – including **India, Malaysia, Mexico, South Africa** and the **United Arab Emirates**

We increased the number of pre-approved local currencies in which UKEF can offer support from **40 to 62**

We introduced a partnership with **5 high street banks** to allow them to provide UKEF support to SMEs without a separate application

We completed our **first ever facility** for a company that is not itself exporting, but is **supplying to an exporter**

We saw a further increase in our direct lending business, introduced in 2014, with **£666 million** of loans made to overseas buyers of UK exports, representing **51%** of total lending to date

We connected nearly **400 UK companies** with **7 multinational contractors** for specific infrastructure projects as they sought UK suppliers due to UKEF's financial involvement

MXN

We completed our **first** ever buyer credit guarantee for a loan in **Mexican pesos**

We supported the delivery of **Bombardier C Series aircraft** to Korean Airlines: the first C Series sale to an Asian airline, and the first UKEF-backed finance for Bombardier, supporting investment and jobs in Northern Ireland

We made our **largest ever** direct loan to an African government, supporting the construction of Kabaale Airport in Uganda

We supported more than **£466 million** of new UK export contracts with our trade finance and insurance products, meaning we have now helped make more than **£4.1 billion** of UK exports happen since these products were introduced in 2011

## Finances

UKEF achieved a net operating income of £5 million for the year ended 31 March 2018 compared with £149 million for the year to 31 March 2017. The decrease was largely the result of a foreign exchange (FX) loss of £65 million for 2017-18 compared with a gain of £57 million in 2016-17. As UKEF is not authorised by HM Treasury to hedge foreign currency exposure, a more meaningful bottom line is an FX-adjusted net operating income figure. On an FX-adjusted basis the net operating income for 2017-18 was £70 million compared with £92 million for the year to 31 March 2017. The remainder of the decrease relates to claims credit, i.e. changes in provision rates on unrecovered claims.

We met all our financial objectives, which are set for us by HM Treasury. Page 23 sets out our results against our financial objectives and pages 60 to 64 provide a comprehensive report of our financial performance.

## Supporting exports through the business cycle

Many of the loans we support by providing guarantees will be repaid over more than 10 years and, in the event of defaults, we will seek to make recoveries. This means that final business losses, as a result of unrecovered claims paid, can take many years to crystallise.

In this regard our role is best assessed 'through the business cycle', as our business levels and claims rise and fall depending on the impact of market disruptions on UK trade. For example, claims payments and recoveries reported in a single year actually reflect business written over a longer stretch of time. Claims paid this year relate to business issued over a 15-year period, between 2001 and 2016. The 6 new claims that arose this year stem from business issued since 2012. Overall, this year, our performance in managing financial risk remains strong. But it is our management of risk through business cycles that is most important. See page 40 for a more detailed commentary on how we have managed financial risk.

## Performance assessment

Assessing our performance should take into account:

- the overall volume of our support (as reported on page 22)
- our ability to provide this support while covering our operating costs and losses
- the potential demand for our services, as required to complement but not compete with the private sector

### Bridging the gap

Our potential market share is partially determined by external factors over which UKEF has no control:

- the regulatory and economic environment and the demand for finance and insurance to support UK exports
- the ability of commercial credit insurers and finance providers to meet the market's demand for finance

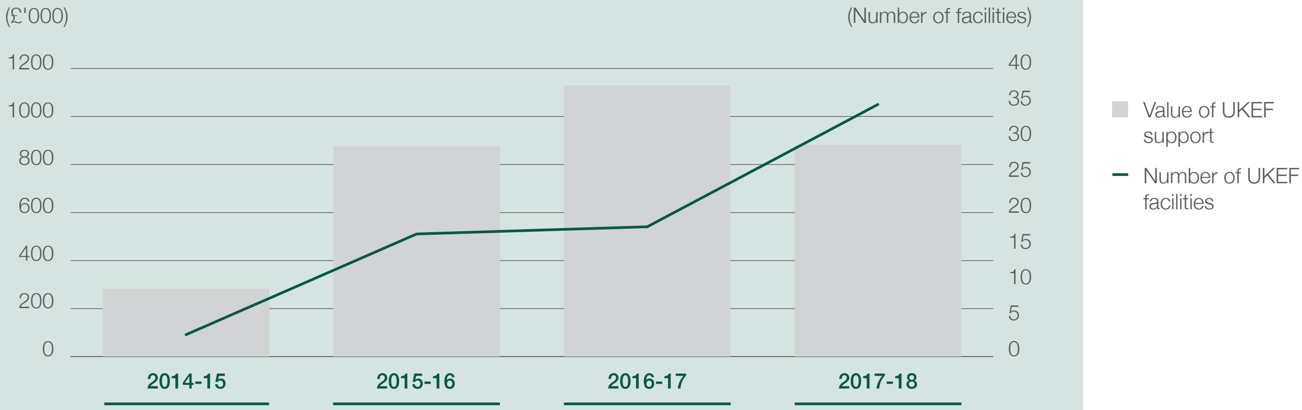
It is also partially determined by factors over which UKEF has a degree of control:

- awareness among exporters of UKEF's ability to help and the willingness of our commercial partners (for example, banks and brokers) to use and promote our services
- our pricing of risk, reflected in the premium and/or interest we charge
- whether we have the product range required to fill particular market gaps

## How UKEF fills market gaps: exports to Ukraine

With the instability in Ukraine since 2014, commercial trade credit insurance for exports to Ukraine became harder to access. In response UKEF has assumed more risk on buyers in Ukraine (in doing so supporting UK exports to these markets). This has helped maintain UK-Ukrainian trade, particularly for exports of fish from Scotland.

### Increasing UKEF support for exports across Ukraine




### Awareness

Getting our support to the right companies, at the right time, continues to be a significant focus, particularly for our trade finance products. We remain, to a large extent, reliant on banks, insurance brokers and other private sector and government networks to introduce business to us.

We have designed, tested and launched a targeted marketing campaign to widen take-up of UKEF support. We will build on this in the next financial year, following the 2017 Budget announcement of a dedicated UKEF campaign under the wider GREAT strategy.

The campaign targets companies most likely to benefit from UKEF's support and features UKEF customers sharing the transformative impact UKEF support has had on their export business.

Internationally, we have so far appointed 6 finance specialists based in key overseas markets (Brazil, Ghana, Indonesia, Turkey and two posts in UAE). They will each lead engagement with local buyers, project sponsors and associated stakeholder networks to develop UK export growth in these markets and surrounding regions with the offer of UKEF-supported finance.

We continue to:

- engage banks by offering training to their frontline staff on how they can work with UKEF to better support their clients
- work with colleagues across the Department for International Trade to embed our finance offer within the broader offer of trade and investment support
- offer training to staff across the Department for International Trade in the UK and overseas on UKEF's financing options
- work with trade associations and membership organisations to amplify our offer

There is a review of our work with partners on pages 38 to 39.

## Pricing of risk

We support UK exporter competitiveness through the lowest premium rates permissible, subject to meeting our financial objectives and aligning with our international obligations, most notably the minimum rates set out by the OECD. Our pricing methodology is described in more detail on pages 48 to 51.

## How we protect the taxpayer

We price risk to enable us to operate at no net cost to the taxpayer over time.

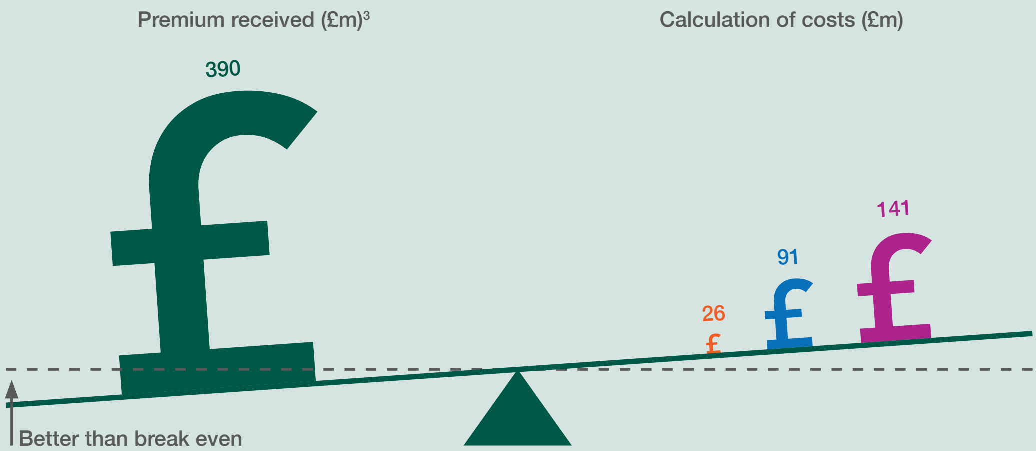
Our aim is to break even over business cycles. To help make sure that we do, every month we calculate the premium we earn and weigh it up against an estimate of all the potential costs and losses for the business supported.

We measure this over different 3-year periods. The diagram below shows the result based on actuals for 2015-16 to 2017-18. The costs have 3 components:

£ a statistical estimate of potential losses that cannot be recovered
£ administration costs
£ a further amount to allow for a portion of unexpected losses

### 2015 to 2018

This measure, called a pricing adequacy index, provides assurance that our pricing is sufficient




to meet all potential costs for the business supported. The position this year has not moved significantly from 2016-17, but moved slightly away from break even.

## Product range

UKEF's broad product range, strong guarantee, flexible foreign content rules and innovative approach are all advantages for UK exporters. Feedback from trade bodies such as the British Exporters' Association (BExA), and trade press such as Global Trade Review and TXF: Trade & Export Finance recognises these strengths. The strength of our guarantee in financial markets continues to be assured by our longstanding status as a ministerial government department with access to the Consolidated Fund.

3 The premium amount for 2015-18 applied to our pricing adequacy index differs from the accounted premium reported on page 112. This is because the accounted premium:
- does not include premium from direct lending, which is amortised as interest income
- uses an exchange rate fixed at the time premium is received (rather than month-end rates)
- includes only the premium earned in the period (rather than the entire premium expected over the life of the business issued)

We continue to explore potential product developments where there is unmet but viable demand, including for smaller exporters that, due to their size, are often unable to access the trade finance support of their bank. The Chancellor of the Exchequer announced in the 2017 Autumn Budget a new supply chain finance product to be introduced in coming months, in addition to the new bank partnership model for distribution and widened eligibility for trade finance.

### Comparing UKEF with other export credit agencies

We assess the strength of our support primarily through listening to our customers and comparing our capabilities against other leading export credit agencies from around the world. Every year we undertake a comparison exercise to review our offering against those of other export credit agencies. We also benefit from external scrutiny provided by the export credit agency benchmarking report produced each year by BExA. Our product range has evolved considerably since BExA's first benchmarking report in 2010, when we scored 4 out of 10, compared to 9 out of 10 for the last 4 years.

## Other performance factors

### Risk management

Managing risk is at the heart of our business model. In addition to the management of credit risks, we face a variety of other risks (financial, operational, strategic and legal) from external and internal sources.

As an export credit agency our credit risk portfolio will tend to be characterised by:

- a higher risk profile than commercial lenders or insurers
- a strong emerging market risk component
- long risk horizons
- occasional risk concentrations (sectoral and/or geographic)

In this context, the low volume of new claims in each of the past 5 years, from a portfolio of around £20 billion at risk, demonstrates a strong capability in managing credit risk.

Taking the last 5 years, the average claims paid as a proportion of the average amount at risk would be 0.037% or:

**£1 for every £2,681 at risk.**

We typically seek to recover claims we have paid, so any final loss calculation may not become clear for many years, until recovery action is concluded. A detailed explanation of how we manage our financial risks is on pages 40 to 59.

We are also committed to managing operational risk, which involves the possibility of error, oversight or control failure leading to financial loss (other than as a result of properly managed exposure to credit risk), or a failure to properly discharge our obligations.

To manage these risks, we are committed to maintaining a culture of awareness and openness, enabling risks to be recognised, evaluated and mitigated.

Our most significant strategic risks at present arise mainly from our need to:

- operate in a continuously shifting global trade policy environment
- respond appropriately when counterparties appear not to have met their obligations in relation to anti-bribery and corruption policies
- attract and retain the right people where salary levels lag behind private sector financial services and other public-sector comparators

There is a detailed description of the most significant operational risks facing our business and mitigating measures in the governance statement on pages 76 to 85.

### Operational efficiency and effectiveness

We have a continuing programme of investment in digital technology and services to improve the efficiency of our case processing and customer relationship management, and to prepare for an increased uptake of our products and services.

The 2015 Spending Review committed us to cost savings of 15% by 2020, but these can be reinvested to support measures to transform the business and drive efficiency. These transformative measures are:

- Technology change, to improve the reliability, scalability and capability of our IT systems, including the exploitation of Management Information (MI) and a move towards a 'digital-by-default' approach, and to reduce operational risk
- Service redesign, including improvements to product access for customers and processing by UKEF
- Organisation and workforce change, including introducing a new operating model for UKEF's Business Group to achieve more efficient use of our talent across sectors and products right through the cycle, and the introduction of an enhanced business development function

Progress on implementing these changes is reported on page 39.

## The year ahead

As we enter 2018-19, the second year of our three-year business planning cycle, our focus is simple: on our customers, both new and established.

### Growing our business

As a core GREAT campaign partner, and following the establishment of an enhanced business development, marketing and communications function, we will develop our relationships with our customers in the UK and around the world to drive business volumes and value.

In 2018-19, we will:

- Launch a UK and international marketing campaign under the GREAT umbrella to connect with new customers and increase understanding of UKEF support
- Develop and roll out more widely our supplier fair programme to maximise the benefits of UKEF support for the UK supply chain

### Enhancing our products

Building on the enhancements delivered this year to our trade finance and Overseas Investment Insurance products, our Business Plan commits us to a continuing evolution of our products in line with market intelligence and industry best practice.

In 2018-19, we will:

- Complete a comprehensive review of all of our products, working with a wide range of stakeholders, to identify improvements to help us use them more effectively and flexibly
- Continue to identify new product opportunities to take full advantage of UKEF's statutory powers in support of UK exports while protecting taxpayers' interests
- Introduce new and revised products to deliver what our customers need

### Improving our digital services

Developing digital services to meet our customers' and staff's needs is a core priority for UKEF, improving our operational effectiveness and transforming our users' experience.

In 2018-19, we will:

- Continue to develop our digital services including our web presence and tools to improve user experience and support business development
- Further improve UKEF's data, systems and processes to support robust, transparent and efficient decision making and reporting

### A great place to work

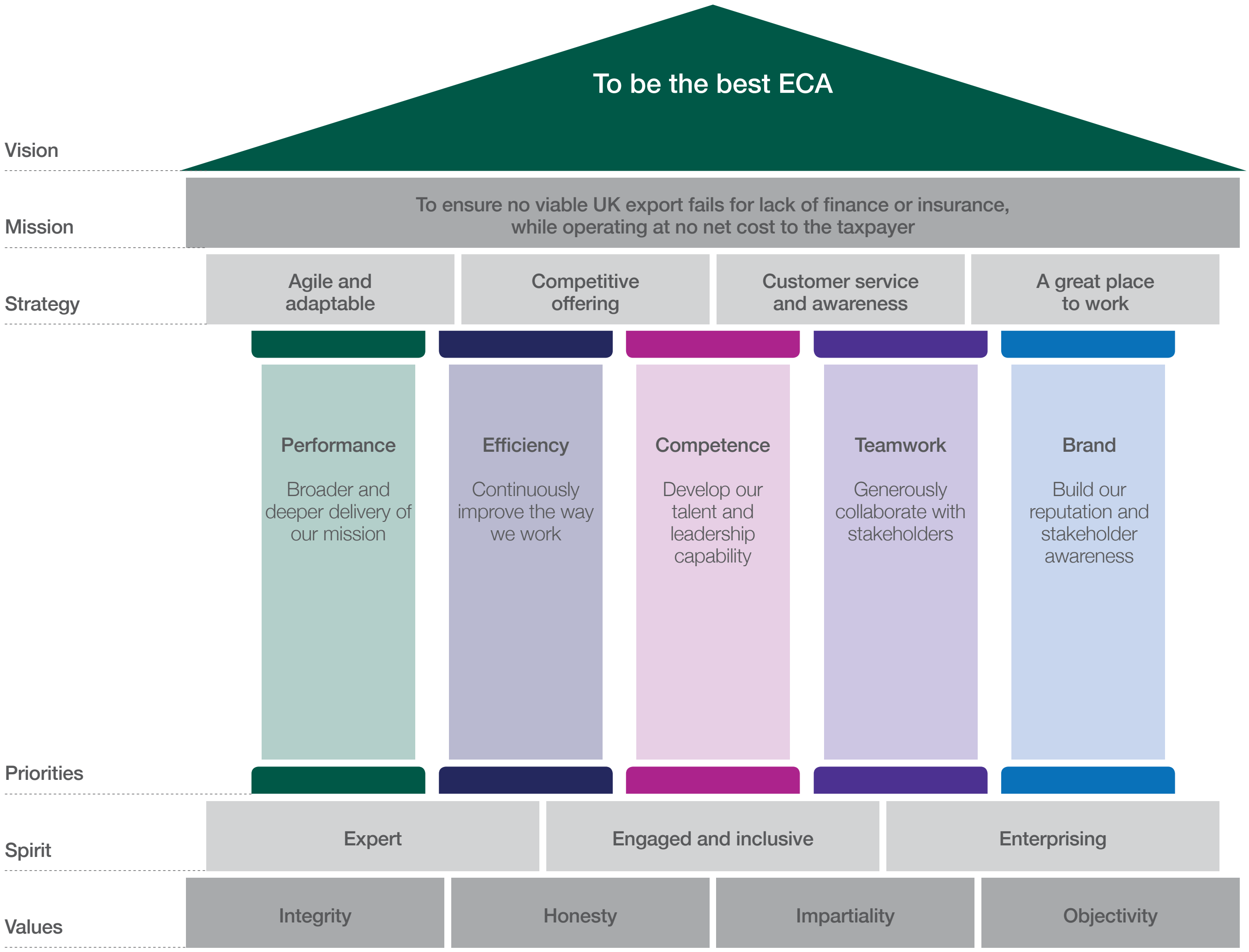
Our ambition is to have the most engaged workforce in the Civil Service, continuing to improve our employee engagement, build a diverse workforce and help our staff develop their careers.

In 2018-19, we will:

- Build on recent successes to diversify our workforce including meeting the targets set out in the Women in Finance Charter
- Embed the operating model we put in place following our transformation programme, supporting staff with a unique and comprehensive learning and development offer

## UKEF message house

UKEF's message house sets out the vision, mission, strategy and priorities of our Business Plan, as well as the spirit and values with which we will achieve these:




I am content that this, and the performance reports that follow, are a fair and balanced account of our performance in the year.

Louis Taylor
Chief Executive and Accounting Officer
12 June 2018

# Performance overview

## Financial overview – 5 year summary

| | 2017-18 £m | 2016-17 £m | 2015-16 £m | 2014-15 £m | 2013-14 £m |
|---|---|---|---|---|---|
| Business supported | 2,530 | 2,966 | 1,793 | 2,730 | 2,272 |
| Premium income | 103 | 102 | 73 | 104 | 120 |
| Claims paid | 2 | 8 | 5 | 6 | 13 |
| Net operating income | 5[4] | 149 | 106 | 129 | 50 |

## Non-financial indicators – 5 year summary

| | 2017-18 | 2016-17 | 2015-16 | 2014-15 | 2013-14 |
|---|---|---|---|---|---|
| Total exporters supported, of which: | 191 | 221 | 279 | 226 | 130 |
| direct support under a UKEF product | 145 | 148 | 176 | 160 | 130 |
| private market assist | 45 | 71 | 100 | 66 | not recorded |
| direct support and private market assist | 1 | 2 | 3 | 0 | not recorded |
| Facilities issued | 580 | 483 | 593 | 588 | 619 |
| Introductions to other sources of support | 1,328 | 2,267 | 1,778 | 1,339 | not recorded |

4 The fall in net operating income was largely due to foreign exchange losses in 2017-18. See page 60 for further detail.

## Financial objectives

| Objective and description | Results |
|---|---|
| **Maximum commitment**<br>This measure places a cap on the maximum amount of nominal risk exposure (ie the total amount of taxpayers' money that may be put at risk by UKEF). | **Met**<br>The highest recorded maximum exposure in the year was £23.5 billion, against a notional maximum commitment at the time of £61.6 billion (when adjusted for foreign exchange movements). |
| **Risk appetite limit**<br>This limit places a constraint on UKEF's appetite for risk at the 99.1 percentile of UKEF's estimated 10-year loss distribution. | **Met**<br>UKEF's 99.1 percentile of the 10-year loss distribution did not exceed £1.4 billion against a maximum permissible level of £5 billion. |
| **Reserve index**<br>This index ensures that UKEF has accumulated, over time, sufficient revenue to cover possible losses, to a 77.5% level of confidence. | **Met**<br>The reserve index did not fall below 4.28 in the year, against a target minimum of 1.00. |
| **Pricing adequacy index**<br>This index tests whether, over time, UKEF earns sufficient premium income to cover all its risk and operating costs. It is measured over 3 different periods: | |
| (i) past 2 years and present year. | **Met**<br>This index at 31 March 2018 was 1.51, against a target minimum of 1.00. |
| (ii) previous, present and next year. | **Met**<br>This index did not fall below 1.49, against a monthly target minimum of 1.00. |
| (iii) present year and next 2 years. | **Met**<br>This index did not fall below 1.47, against a monthly target minimum of 1.00. |
| **Premium to risk ratio**<br>This measure ensures that each year UKEF charges enough premium to cover the cost of risk, together with a sufficient margin to contribute a material amount to administrative costs. | **Met**<br>This ratio did not fall below 2.33, against a target minimum of 1.35. |

Pages 40 to 59 set out more detail on these objectives.

**Note:** These financial objectives apply to business issued since 1991. There are no specific financial objectives in respect of outstanding exposures on business supported before 1991 other than to recover amounts due in respect of claims paid, in a manner that optimises the return to taxpayer, while taking account of the government's policy on debt forgiveness.

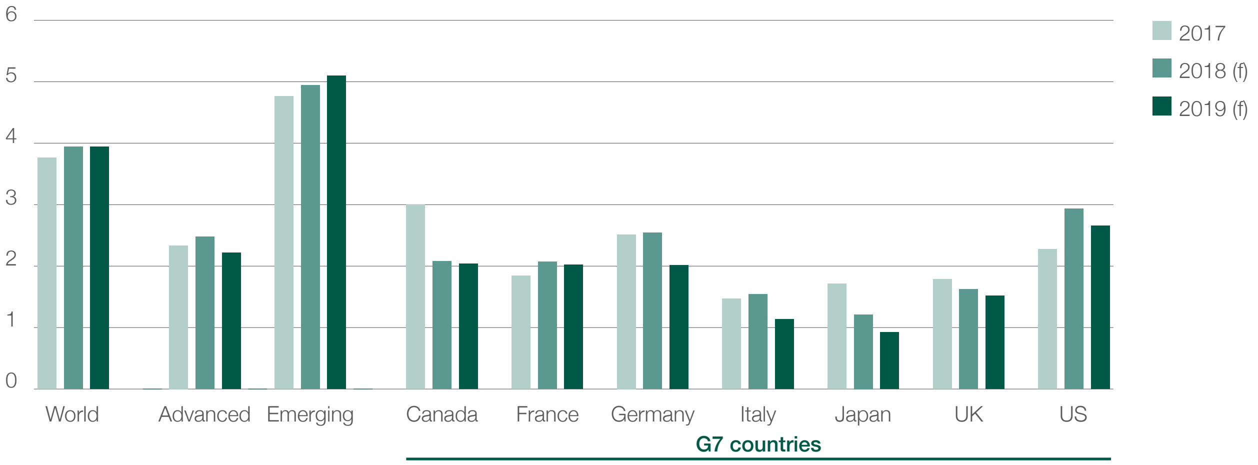
# Economic snapshot

## Global growth – a synchronised upswing with a note of caution

Global economic activity has remained robust, with both advanced and emerging markets continuing to perform well. Global trade and investment have picked up, commodity prices are recovering, business confidence has generally improved, financing conditions remain relatively attractive in the face of subdued inflation and unemployment rates have fallen. In January, the IMF upgraded its forecasts for world economic growth for the period up to 2019, describing the current situation as the 'broadest synchronised global growth upsurge since 2010.'

### Global economic activity

GDP growth (% change year-on-year)




*Source: IMF World Economic Outlook (WEO) – April 2018*

The US, already near full employment, is expected to exceed its potential growth rate fuelled by tax cuts and other fiscal measures. Many of the euro area economies, especially Germany, Italy, and the Netherlands, have seen strong momentum in domestic demand.

However, this positive picture should not disguise continued challenges for advanced economies, notably weak productivity, ageing populations and the risk of governments adopting protectionist policies.

## Emerging and developing markets – well-grounded growth

Output growth in emerging markets is expected to reach nearly 4.9% in 2018 compared with 4.8% in 2017. Commodity exporters have fared particularly well as metals and oil prices have averaged over 20% higher in 2017 compared to 2016.

Asia contributes around half of global growth, with Asian emerging markets continuing to register strong growth at around 6.5%. The modest slowdown in China (6.9% in 2017 to 6.6% forecast for 2018) is linked in part to its rebalancing policy of transitioning from investment to services and private consumption as well as slowing credit expansion. Asia's economic prospects could be significantly impacted by US tariffs as many of the goods concerned involve supply chains that stretch across the region, particularly Vietnam, Malaysia and the Philippines. As export-led economies, a potential escalation of trade tensions represents the most significant near-term risk for the region. With a relatively closed economy India's growth (6.7% in 2017 to 7.4% forecast for 2018) is more insulated.

In Latin America and the Caribbean, the recovery in growth (from 1.3% in 2017 to 2.0% forecast for 2018 and 2.8% for 2019) primarily reflects an improved outlook for Mexico (benefiting from stronger US demand) and recovery in Brazil. Despite improving commodity prices, Venezuela continues to struggle on the back of falling oil production.

Growth in the Middle East and North Africa is also expected to pick up in 2018 (3.2%) and 2019 (3.6%), from 2.2% in 2017, as higher oil prices spur a recovery in domestic demand, including in the region's dominant economy, Saudi Arabia. Geopolitical and regional tensions remain risk factors that could interrupt the oil-led recovery.

Sub-Saharan Africa growth (from 2.8% in 2017 to 3.4% forecast for 2018 and 3.7% for 2019) reflects Nigeria's recovery from recession and South Africa's expected upturn in the wake of a return of confidence and investment following the smooth transfer of presidential power.

Overall, this is an encouraging outlook for the world economy, particularly for emerging markets – UKEF's primary focus – and indicates a positive outlook for the Department's business.

It remains important to maintain vigilance; the IMF warns that 'the overarching risk [to economic growth] is complacency.' While growth looks generally well grounded, leverage remains extremely high. According to the IMF, total global public and private debt has reached an all-time high of $164 trillion – up 40% on its 2007 level. At the same time concerns over potential asset bubbles – the S&P 500 has risen over 150% since 2009 – the prospect of higher interest rates and tighter financing conditions, allied to limited fiscal space to counter a downturn or economic shocks, also need to be borne in mind looking forward.

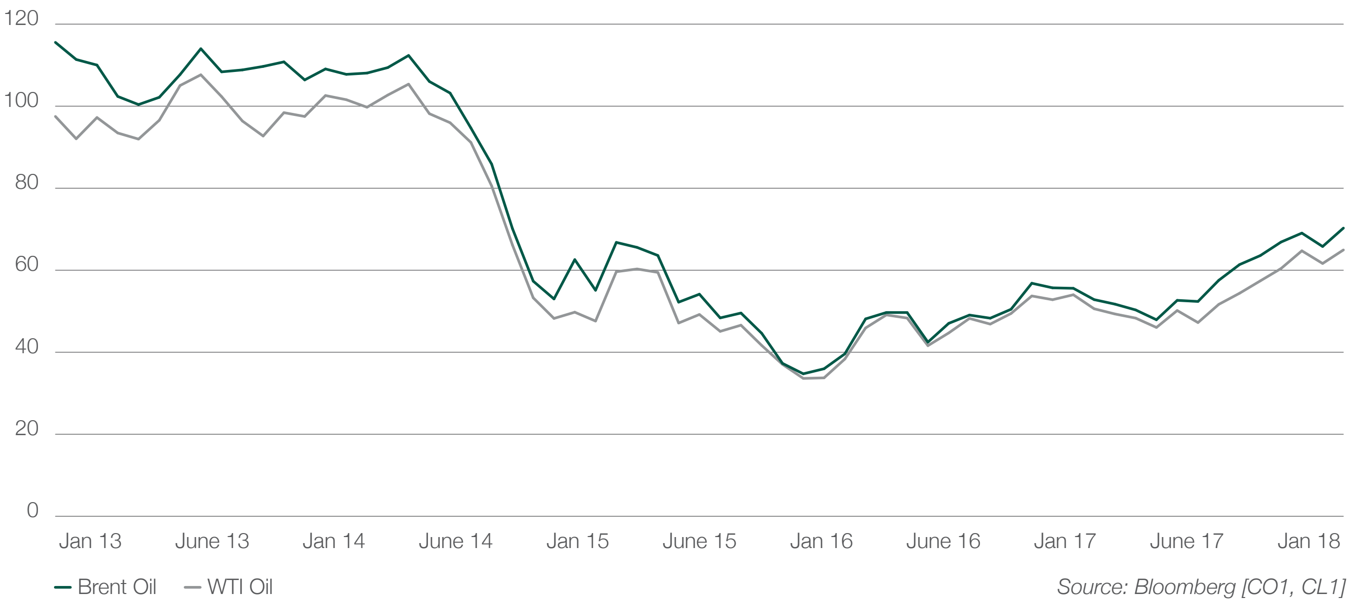
## Commodity prices – oil price upturn

The agreement between members of the Organization of the Petroleum Exporting Countries (OPEC) and key non-cartel oil producers to constrain production, implemented in January 2017 and further extended to the end of 2018, has seen oil prices rebound. In addition, the US' withdrawal from the Joint Comprehensive Plan of Action with Iran added further pressure to prices, which increased to around US$80 a barrel in May 2018. OPEC and non-OPEC production cuts and demand growth are leading to the long-awaited rebalancing of the market. However, OPEC faces a tricky exit from cuts next year at a time of resurgent US shale production, which looks likely to make the US the largest oil producer in the world by 2020.

While market fundamentals will continue to drive oil prices, geopolitical factors raise the risk of instability and supply disruptions. Indeed, the political risk premium in oil prices will feature more prominently as lower OECD oil inventories will be less able to alleviate supply shocks.

### Oil prices

(US$/bbl)

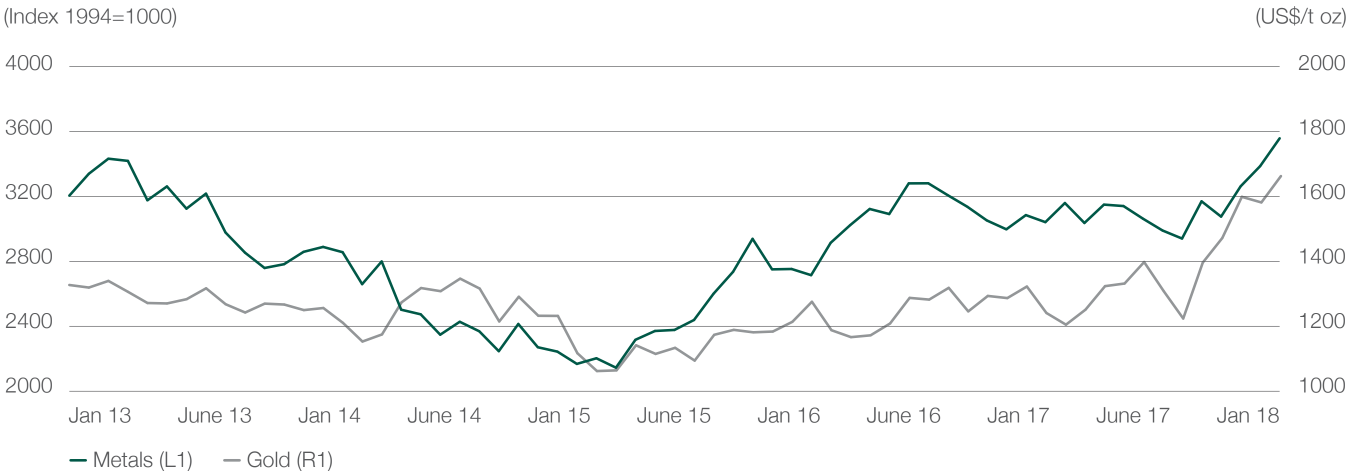



*Source: Bloomberg [CO1, CL1]*

Metal prices, as measured by the London Metal Exchange Index (LMEX), rose through 2017 in tandem with the global upswing, coupled with demand from the proposed $1 trillion infrastructure spending programme in the US. The LMEX dropped following the announcement of tariffs, which have the potential to dent global demand. On the other hand, the expectation of increased infrastructure investment in the US alongside the global economic uptick could help to boost prices further.

Gold prices have recorded significant gains; as a safe-haven asset, prices tend to move in line with volatility expectations, and reflect geopolitical tensions and financial market uncertainty.

### Metals

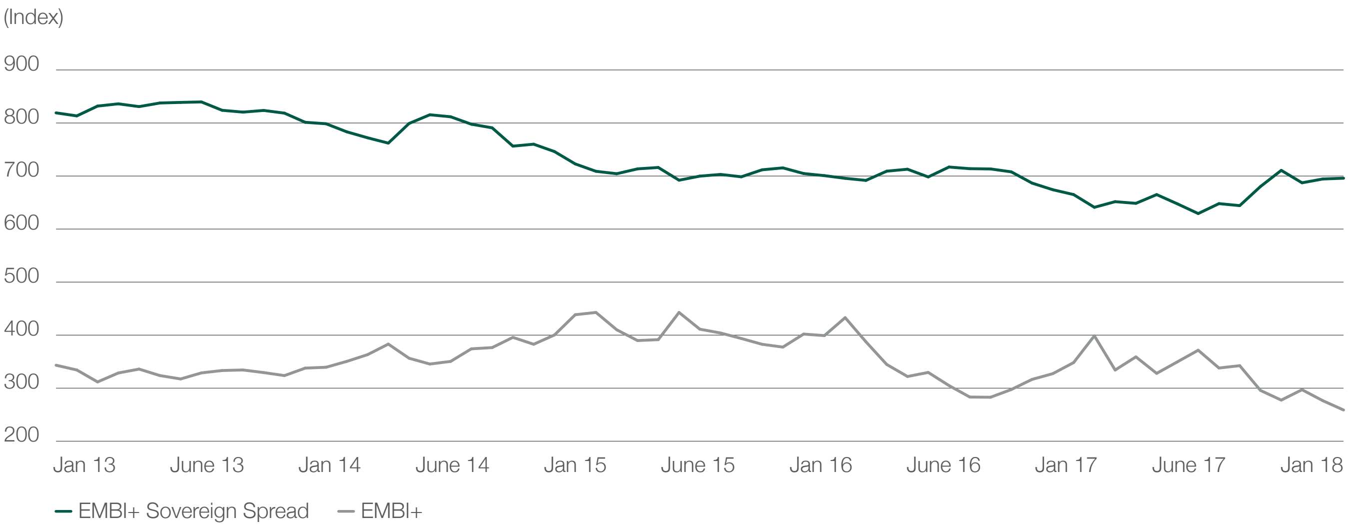



## Financial markets conditions

Global financial markets continue to perform well, bolstered by expanding economic activity in an environment of low inflation and still-accommodative monetary policy from key central banks which is perpetuating the search for yield. Almost all assets are posting strong gains, with equity markets recently hitting record highs, and corporate bond yields still at relatively low levels. However, with the US Federal Reserve in tightening mode and the European Central Bank (ECB) possibly looking to end its asset purchase programme in the near term, liquidity is becoming constrained with consequential impact on pricing.

Highlighting the improving outlook for emerging markets, the J.P. Morgan Emerging Market Bond Index Plus (EMBI+) (which measures the performance of international government bonds issued by emerging market countries) continued rising through 2017. However, more recently, the spread has started to increase due to economic uncertainty in some emerging markets, such as Argentina and Turkey.

### Emerging Market Bond Index Plus (EMBI+)

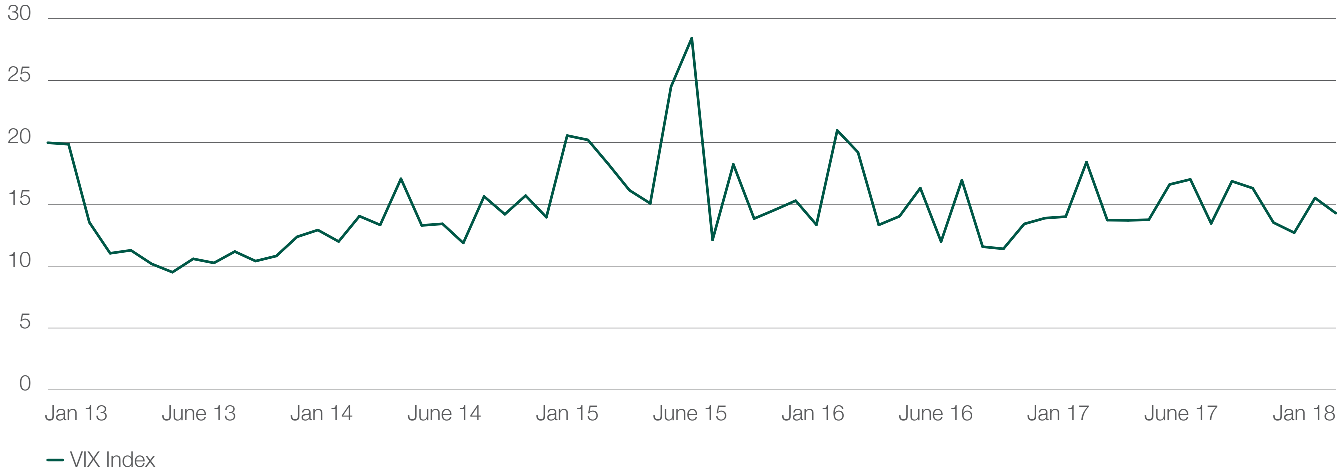


US moves to normalise monetary policy have raised concerns over a potential reversal of capital flows from emerging markets if policy interest rates move up sharply and substantially. However, clear and timely communication from the central banks of advanced economies have so far helped to minimise uncertainty.

The Chicago Board Options Exchange Volatility Index (VIX), a popular measure of the stock market's perception of future volatility, remained on a downward trend in 2017, although it has since risen due to concerns about protectionist policies. The absolute value as well as the trajectory of the index can be used as one gauge of investors' risk expectations.

### Chicago Board Options Exchange Volatility Index (VIX)

(Index)




## UK economy

The UK economy grew by 1.8% in 2017, slightly higher than the 1.7% estimated in the IMF's January 2018 World Economic Outlook (WEO). Although the IMF anticipates moderate weakening in 2018 (1.6%) and 2019 (1.5%), unemployment remains low (below 4.5%) and the pound generally appreciated over 2017. The depreciation of the dollar has been a major factor in this.

UKEF stands ready to support the UK corporate sector, particularly smaller companies, through trade finance products such as working capital and bond support. These products can help exporters to exploit fully the opportunities available to them, especially where uncertainty is limiting credit availability.

## Outlook for 2018-19

The outlook for the global economy remains broadly positive, although a number of downside risks persist including protectionist policies.

Rising global activity is likely to be a positive spur to UK exports and in turn support UKEF's business volumes. Global infrastructure requirements remain significant and export credit agencies will be required to play a significant role in supporting long-term financing to address funding gaps, especially where private sector provision may be lacking owing to rising uncertainty and/or new international banking regulations. There continues to be an important role for UKEF to help companies seize export opportunities worldwide by deploying its capital and funding capacity.

# How we operate

**UKEF's statutory purpose is to support UK exports and overseas investments.**

We do so principally by providing:

- guarantees to banks and investors in the debt capital markets in respect of medium- to long-term loans to overseas buyers who purchase goods and services from UK exporters
- lending directly to overseas buyers who purchase goods and services from UK exporters
- guarantees to banks to support working capital financing and the raising of contract bonds on behalf of exporters
- trade credit insurance to exporters against the risks of non-payment for amounts owed under export contracts
- political risk insurance for investments made overseas

UKEF supports exports of all types of goods, services and intangibles, and can help businesses of all sizes that seek protection from the financial risks of exporting.

In doing this, our role is to complement the private market: we seek to support exports that might otherwise not happen, thereby supporting UK exporters and their supply chains. The space in which we operate is largely determined by the willingness and capacity of the private market to assume financial risks in support of exports at any given time. We are also bound by EU restrictions on member governments supporting short-term export credit insurance for exports to EU countries (currently excluding Greece) and rich Organisation for Economic Co-Operation and Development (OECD) countries (for example, the US).

The financial liabilities we assume when supporting exports involve a transfer of risk from the private to public sector. Direct lending involves upfront public expenditure (repayable over time) while other financial liabilities represent contingent public expenditure – that is, taxpayer funding is required only in the event of claims being made on insurance policies or guarantees provided to banks. When claims are made, we instigate appropriate recovery action on a case-by-case basis or, where there is a sovereign default, through the Paris Club of official creditors to recoup the relevant payments.

UKEF operates under the consent of HM Treasury, which sets financial objectives that we must achieve. These, and the credit risk and pricing policies we operate to meet them, are set out on pages 40 to 59.

We also operate under international (principally OECD) agreements that seek to create a 'level playing field' by setting terms under which export credit agencies can support exports. However, not all export credit agencies are party to these international agreements and competition for UK exporters is increasingly from non-OECD countries whose export credit agencies are not bound by these agreements.

## Principles applied by UKEF

On individual cases, we aim to:

- provide a quality of service that is proactive, flexible and efficient, with a focus on solution and innovation
- take account of factors beyond the purely financial, and of relevant government policies in respect of environmental, social and human rights risks, debt sustainability, and bribery and corruption

Generally, we aim to:

- publish guidance for applicants on the processes and factors we take into account in considering applications
- achieve fairer competition by seeking to establish a 'level playing field' internationally through obtaining multilateral agreements in export credit policies and practices
- recover the maximum amount of debt in respect of claims paid, taking account of the government's policy on debt forgiveness
- abide by such codes of practice and guidelines on consultation as may be published by the government from time to time
- be a great place to work, recruiting, developing and retaining the people we need to achieve our Business Plan objectives

## Our export solutions

Our support for UK exports can be categorised as long-term (export credit) and short-term support (trade finance).

**Export credit support** typically covers exports of capital/semi-capital goods and related services, for example large projects or high value machinery. Due to the high values involved (normally £5 million to more than £1 billion), overseas buyers frequently require loans (usually repayable over 5-10 years, or longer) to finance the purchase of such supplies from UK exporters. We provide support under our finance products (such as buyer credit guarantees) to banks that provide export credit loans, thereby covering the risk of default by borrowers. Alternatively, we can lend to buyers directly.

**Trade finance support** typically covers consumer or intermediate goods and services, for example, consumer durables or light manufactured goods. These goods are typically sold on short credit terms (up to 1 year), which exposes exporters to (a) risk of non-payment, and/or (b) the need to finance working capital (pre-shipment financing) and the credit period (post-shipment financing). We have products designed to meet these challenges which are available to exporters and in some cases to their direct suppliers.

## Export solutions

| | | | | |
|---|---|---|---|---|
| Longer term credit (2 to 18 years) | **Export credit solutions**<br>Supporting finance for overseas buyers of UK exports | • Providing guarantees to banks on the loans they give to overseas buyers to purchase goods and services from the UK<br>• Direct lending to overseas buyers so that they have the funds to purchase goods and services from the UK | • Buyer credit facility<br>• Supplier credit facility<br>• Direct lending<br>• Lines of credit<br>• Export refinancing facility | Lower volume, higher value |
| Shorter term credit (less than 2 years) | **Trade finance solutions**<br>Supporting UK exporters | • Reducing or removing the risk of non-payment by overseas buyers<br>• Helping to support a bond required under the terms of a contract<br>• Supporting working capital | • Export insurance<br>• Bond insurance<br>• Bond support<br>• Letter of credit<br>• Export working capital | Lower value, higher volume |

## Investment

Access to UK Export Finance's products and services can provide an incentive for companies to base their international business in UK, supporting foreign direct investment (FDI) into the UK.

We can also support overseas direct investment by insuring UK investors' overseas projects against certain political risks, helping to secure inward flows of dividends and gains to UK frontline overseas investments.

# Our support for exports

| Businesses supported | |
|---|---|
| Exporters supported | 191 |
| Value of support provided | £2.5 billion |
| Destination countries | 76 |
| Largest single facility | £271 million (buyer credit) |
| Smallest case | £1,565 (bond support) |
| Most popular product | Bond support (67 companies) |
| Highest value product | Buyer credit (£1.3 billion) |

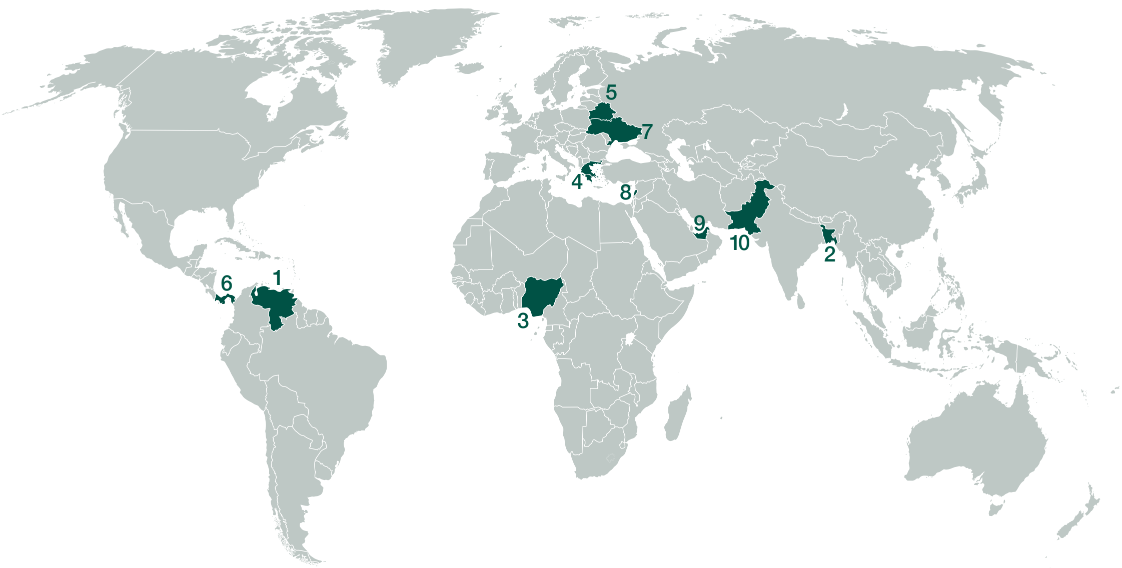
**Gordon Welsh**
Business Group Director

## Making trade finance more accessible

UKEF's short-term trade finance support allows exporters to access finance from their banks to support export activity where otherwise they may not be able to. In many cases, this will be the critical factor that allows an exporter to fulfil their contract.

Support is available in the form of guarantees under our bond support and export working capital support schemes. We also provide insurance for exporters, principally against the risk of non-payment, where the commercial market cannot provide cover.

### Export insurance: top 10 markets by value in 2017-18




1. Venezuela
2. Bangladesh
3. Nigeria
4. Greece
5. Belarus
6. Panama
7. Ukraine
8. Lebanon
9. Abu Dhabi
10. Pakistan

In 2017-18, UKEF supported contracts worth £466 million through our trade finance and insurance products, as well as helping 46 companies obtain the finance or insurance they needed from private providers.

Since 2011, when our trade finance products were introduced, we have supported £4.1 billion in export contracts.

This financial year, we delivered two important innovations to improve businesses' access to trade finance:

- Our new bank partnership delivery model
- Widened eligibility for direct suppliers to exporters

### Bank delivery model

In October 2017, UKEF launched its new partnership with banks to streamline the process for providing UKEF-backed trade finance support to smaller customers.

Within pre-determined eligibility criteria and for support up to £2 million per counterparty, companies can now access our bond and export working capital support directly from their banks, without the need to apply to UKEF separately.

These products are now delivered through a trade finance digital service that the exporter's bank can use.

In this first phase, the participating banks are Barclays, HSBC, Lloyds/Bank of Scotland, RBS/NatWest/Ulster Bank and Santander.

This new partnership is an important way in which we can make our trade finance more accessible and its delivery more efficient – a central commitment in UKEF's Business Plan.

### Supporting companies in exporters' supply chains

At the same time, UKEF expanded eligibility for some of its trade finance products, allowing UK companies supplying goods and services to an exporter to access UKEF guarantees on working capital loans and contract bonds.

This means that companies in the supply chain can now access support from UKEF through their banks for the first time, helping them to become part of major export contracts and spreading the benefits of trade to smaller companies – another of our Business Plan commitments.

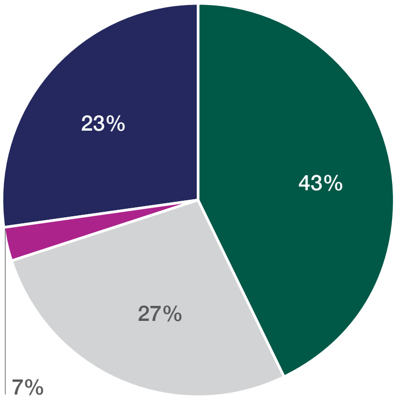
## Overseas investment insurance: supporting business to invest aboard

In October 2017, UKEF launched an enhanced overseas investment insurance (OII) policy, as we committed to do in our Business Plan. This improved product gives UK businesses access to improved long-term cover against a wider set of risks on their overseas investments, for example terrorism.

Our product has been designed to offer support where the private insurance market doesn't have the capacity to provide political risk cover on normal terms, for example, where the private sector has reached country and sector exposure limits, or cannot provide cover for very long-term projects.

## Export credits: helping UK businesses compete successfully in the global market place

### Export credit business supported (medium/long-term) 2017-18




| Sector | UKEF maximum liability, £m |
|---|---|
| Aerospace | 1,053 |
| Civil - direct loans | 666 |
| Civil - guarantees | 556 |
| Defence | 167 |

Export credit support is when UKEF guarantees commercial finance or provides a loan used to purchase goods and services from the UK.

Interest in UKEF's guarantee and direct lending products remains high due to:

- reduced risk appetite and lending capacity for longer tenors among banks
- other governments' budgetary constraints due to low commodity prices and ambitious infrastructure investment

### Sector support

Civil, infrastructure and energy

Construction and energy continue to be significant sectors for UKEF; these projects formed 94% of exposure across deals transacted in the civil, infrastructure and energy area for 2017-18 when measured by maximum liability. Construction in particular has risen as a proportion of our portfolio.


UKEF guaranteed a £375,000 loan to support Midlands-based Garrandale's export contract providing train maintenance equipment to the Sydney Metro Northwest project

Three landmark transactions showed the role UKEF is playing to support international demand for UK transport infrastructure expertise.

The first was buyer credit support for a 1 billion Mexican peso loan for the export of 90 low-emission red double-decker buses made by Alexander Dennis for Mexico City's Bus Rapid Transit network – the first Mexican peso transaction we have supported under our expanded local currency financing offering.


Dr Liam Fox, Secretary of State for International Trade, alongside an Alexander Dennis bus on Mexico City's Paseo de la Reforma

We also provided a direct loan of €270m to support a Colas UK contract to build a runway and associated facilities for a new international airport at Kabaale in Uganda. This was UKEF's largest direct loan to a sub-Saharan African government and represents a major breakthrough in a priority region.

In Ghana, we are supporting the expansion of Kumasi Airport, improving transport links to Ghana's second city to encourage trade and tourism. We have provided a €65 million buyer credit to finance a contract with Contracta UK and more than 20 UK sub-contractors.

Geographically the UAE accounted for over half of civil, infrastructure and energy transactions by maximum liability for 2017-18.

Major transactions included support for several construction projects in the UAE, for example $220 million in support for the construction of the Dubai Arena, a state-of-the-art 17,000-seat multipurpose entertainment venue which Kier has designed and built.

There has also been significant activity in other key priority markets, for example Iraq. Here, we have supported several power projects, helping the Government of Iraq to deliver critical post-conflict infrastructure development.

A developing trend is the increase in transactions supported with a combination of traditional buyer credit and a direct loan (7 of 18 transactions). Direct lending is increasingly seen as a decisive factor for less developed markets, in particular due to the need to access efficient long-tenor fixed rate loans where commercial banking liquidity (including for covered lending) may be restricted.


UKEF provided support for a Kier contract to design and build the 17,000-seat Dubai Arena

## Direct lending

UKEF's Direct Lending Facility, introduced in 2014, can give UK exporters a competitive edge that can be particularly effective in lower income countries – countries where international competitors may be using concessional financing schemes not offered by the UK government, including tied aid. Against this backdrop, UKEF's direct lending resources are being increasingly focussed on projects in developing markets (for example, support for the Kabaale airport in Uganda, outlined on page 33).

In January 2018, UK construction firm Carillion went into liquidation. In recent years UKEF has provided support to a number of projects on which Carillion was the UK contractor. In these cases the support was provided to Carillion's overseas customers to help them buy from the UK. The exposure is therefore to the overseas buyer, not to Carillion itself.

For the majority of Carillion projects that UKEF has supported, construction has been completed, and finance is now being repaid by the overseas buyers as agreed. There are four projects where construction is yet to be completed; in these cases, Carillion's former joint venture partners have replaced Carillion and complete the contracts. UKEF is continuing to support these projects based on substantially the same goods and services being sourced from the UK, supporting the UK construction supply chain.

### Aerospace and defence

This year saw an increase in the volume of support provided for aerospace transactions, which was at a historically low level in 2016-17 when we received no applications for support from Airbus.

The bulk of UKEF aerospace support this year was for the export of Rolls-Royce powered Boeing 787 aircraft. 13 aircraft were delivered with our support to LOT Airlines of Poland, Norwegian Air Shuttle and operating lessor Avolon. These were the first Boeing aircraft to be supported with UKEF as lead ECA.

Support was also provided for the UK share of two Airbus A330 aircraft that were delivered to Rwandair. Given the ongoing Serious Fraud Office (SFO) investigation into the historical use by Airbus of overseas agents, UKEF and our French and German counterparts have developed an extended due diligence framework under which we will assess applications for export credit support from Airbus. The Rwandair transaction was the first such application to be considered under this methodology and, following the successful conclusion of the due diligence process, the first Airbus aircraft to be supported by UKEF since late 2015.

We also supported 4 Bombardier C-Series aircraft delivered to Korean Airlines, working alongside Canadian export credit agency EDC. This was the first time UKEF supported C-Series aircraft, helping to sustain Bombardier's plant in Belfast where the wings and fuselage assemblies for these aircraft are made.

We also continue to support engine overhaul contracts undertaken by GE Aviation facilities in Scotland and Wales. Our assistance, delivered in partnership with the US Export Import Bank, contributes to the security of engineering jobs at these two plants.

Another Northern Irish exporter benefiting from UKEF support in the year was Thales UK. Support of around £164 million was provided for the export of Thales Starstreak missile systems to the Government of Indonesia.

### Reinsurance

UKEF continues to see demand concentrations in key markets. We use our range of reinsurance agreements and new capability to seek reinsurance in the private market to address risk concentrations which ensures UK exporters, and their customers, can maintain access to support for "in-demand" markets while UKEF prudently manages its risk portfolio.

Our ECA reinsurance partners are outlined on page 39 (our partners and operations).

## Bringing business to the UK

In 2017-18, UKEF has enhanced and expanded the 'leading with finance' approach to bringing business to the UK.

This approach, pioneered in 2016-17, identifies major projects with opportunities for significant supply from the UK, and uses UKEF's attractive finance offer to incentivise project sponsors to procure from UK companies. UKEF then works with colleagues across the Department for International Trade – notably in the Posts and sector teams – and with private sector partners to convene a supplier fair to connect project procurement teams with the relevant companies in the UK supply chain. This has resulted in substantial increases in UK content in these projects – and therefore revenue for UK businesses.

Building on the 2 exporter fairs held in 2016-17, UKEF has held 3 in 2017-18, connecting nearly 400 companies with opportunities potentially worth hundreds of millions of pounds in sectors as diverse as healthcare, construction and energy.

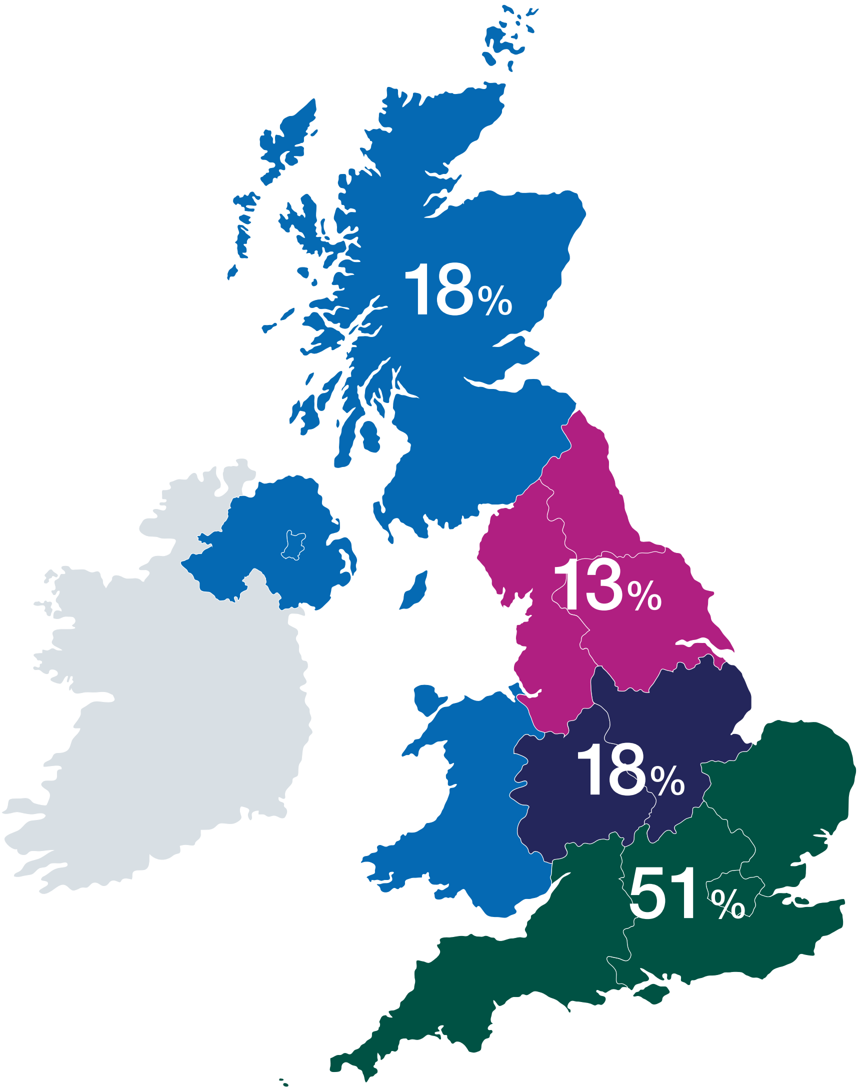
Based on post-event surveys, we also know that on average as many as half of the companies that attend these events find out about other international business opportunities with the project developers and prime contractors.


UKEF held an exporter fair to showcase opportunities with the Duqm oil refinery project in Oman

## On-the-ground support for exporters: export finance managers

We have 24 export finance managers (EFMs) across the UK, who act as local points of contact to introduce exporters and businesses with export potential to finance providers, credit insurers, insurance brokers, trade support bodies and sources of government support, including from UKEF.

**Proportion of companies benefiting from trade finance or insurance by region in 2017-18**




This presence across the UK makes a significant contribution to our drive to increase awareness and uptake of UKEF and its products among small and medium-sized exporters all over the country. EFMs develop relationships on a local basis, providing on-the-ground support for exporters across the UK. This year, EFMs held nearly 2,000 meetings with businesses, providing face-to-face guidance on trade finance options to support their exports, and a further 1,300 with intermediaries including banks and brokers.

In addition to helping companies access UKEF products, EFMs deliver “private market assists” – when their engagement makes a material contribution to a company receiving support from the private sector, resulting in an export contract going ahead that was unlikely to have proceeded otherwise. EFMs also made more than 1,300 referrals to third-party sources of support.

There were 166 referrals from our export finance managers to services provided by other parts of the Department for International Trade, Scottish Enterprise, Business Wales or Invest Northern Ireland.

“Overseas sales are a hugely important part of Norton’s business and our growth plans for the future. The bespoke support we have received from UK Export Finance has meant that we can realise our ambitions secure in the knowledge that our finance matches our plans.”

- **Stuart Garner, CEO**, Norton Motorcycles

# Our partners and operations

**UKEF couldn't operate without its network of partners. We aim to collaborate as generously and purposefully as we can, to widen the support we provide to our customers while ensuring that our partners also benefit in kind from working with us.**


## Our partners

**Commercial finance partners – lenders:** UKEF provides guarantees to commercial banks when they extend trade and export finance support to their customers. This year, we launched our new partnership model for delivering trade finance support with five major high-street banks, outlined on page 31. We are also working to improve our customers' experience accessing UKEF support through these partners, a project that will continue into the new financial year.

We supported trade promotion programmes with two banks, enabling collaboration between the banks, UKEF and other parts of the Department for International Trade to bring new opportunities to UK businesses and support their growth aspirations.

**Commercial insurance partners – brokers:** In the same way as commercial lenders play a critical part delivering our trade finance products, commercial insurance brokers are important as our route to market for our insurance products.

**Export credit agencies:** In 2017-18 we worked with a number of other national export credit agencies to deliver export credit support where contracts included content from third countries. These included Export Development Canada, Nippon Export and Investment Insurance (Japan), Swiss Export Risk Insurance, Servizi Assicurativi del Commercio Estero (Italy), Banque Publique D'Investissement (France), Euler Hermes (Germany) and Compania Espanola de Seguros de Credito a la Exportacion (Spain).

**Other government departments:** As well as collaborating with colleagues across the Department for International Trade, UKEF works closely across HM Government to leverage other departments' relationships with UK exporters, overseas buyers and intermediaries such as banks. This year, we have built on relationships with key departments including the Foreign & Commonwealth Office, the Department for Business, Energy and Industrial Strategy, HM Treasury, the Department for Transport, the Department for International Development and the Infrastructure Projects Authority, to extend an integrated offer of UKEF products and support to their stakeholders.

**Industry bodies:** Following on from our successful collaboration with the Energy Industry Council and NOF Energy last year to promote supplier fairs to their membership base, we partnered with several trade associations across the oil and gas, nuclear, renewable energy, healthcare, construction, engineering and manufacturing sectors to support the three similar events held this year.

We continued to work with business representative organisations including the British Chambers of Commerce, Confederation of British Industry, Engineering Employers' Federation, Federation of Small Businesses, Institute of Directors and British Exporters' Association to consult on policy and product development and promote UKEF's support to their memberships.

**Intermediaries:** Intermediaries such as accountants and lawyers are trusted advisors for their customers, and have the potential to be an important referral channel for UKEF. We have therefore developed and delivered a programme of enhanced engagement with new and existing partners in the sector, including trade bodies such as the Institute of Chartered Accountants in England and Wales and Association of Chartered Certified Accountants and commercial partners, for example PwC, with a view to improving understanding and driving referrals.

## Our operations

In 2017-18, the transformation programme has aimed to equip UKEF with the necessary infrastructure and resources to become more user-focused and operate digitally by default. This builds on significant investments in 2016-17 to improve underlying IT infrastructure.

In 2017-18, the transformation programme delivered improvements to numerous systems to enhance efficiency and scalability in UKEF's operations, including:

1. UKEF's new bank partnership delivery model and bespoke digital service for trade finance products
2. A multi-division transaction workflow solution, fully integrated with the digital service used by banks, to make the transaction process more transparent and efficient for our partners
3. An enhanced customer relationship management system to further improve customer engagement
4. A new human resources (HR) management system to make HR administration more efficient
5. An enhanced "Ideas Lab" process to encourage employees to share ideas of ways to improve UKEF products, systems and processes
6. Improvements to our direct lending operational process to begin streamlining and automating delivery
7. A new document storage and management system to improve our case management processes

We also reorganised the Operations function to better equip it to deal with higher volumes of business of greater complexity. We set up a new Operational Service Delivery team to continue to improve support for users of UKEF's digital services, invested in the Change, Innovation and Delivery division to support departmental change and reorganised the commercial and procurement function to improve the quality of contract and procurement management across the department. We have also invested in technology, assets, processes and people to support greater automation to improve efficiency.

# Credit risk, portfolio overview and pricing report

## Financial risks

**The principal financial risks to which UKEF is exposed are credit, market and liquidity risk:**

**Credit risk: the risk of financial loss if an obligor or counterparty against which we have financial exposure fails to meet its contractual obligations.**

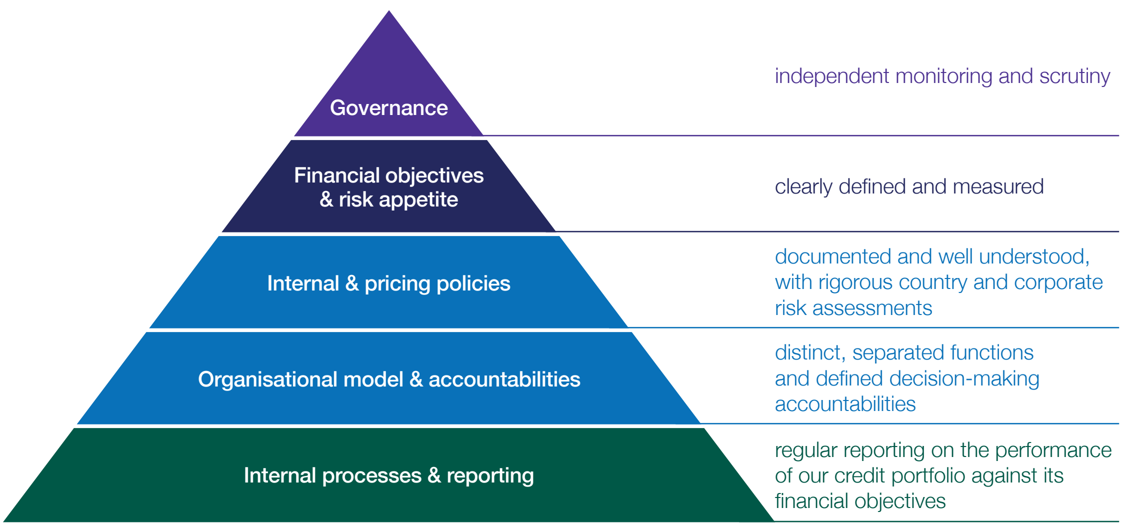
**Market risk: the risk of losses due to changing market prices, such as fluctuations in foreign exchange rates and, to a lesser extent, interest rates.**

**Liquidity risk: the risk that we do not have the resources to meet our financial obligations when they fall due, or can only do so at excessive cost. However, UKEF's status as a government department enables us to obtain public funds.**

All of our risk management operations aim at least to match the financial services industry's best practice standards. However, given our role as a government-backed export credit agency, the relative importance of different risk types differs from that of the private sector.

Credit risk is the most significant source of financial risk for UKEF. Its management is a core competency for the department, which is reflected in our credit risk management framework and operates at every level of the department, as set out below:

### UKEF's credit risk management framework




Similar principles apply to the other sources of financial risk, and the framework for managing each varies accordingly.

## Credit risk management

### Context

Parliament sets an overall limit of SDR67.7 billion[5] on the commitments that UKEF may enter into. UKEF's powers may only be exercised with the consent of HM Treasury (HMT). The limits of this consent are agreed with HMT, along with financial objectives and reporting requirements that serve to regulate the risk we take on.

As the UK's export credit agency (ECA), our role, mandate and risk appetite differs from the private sector. So, while we do compare our credit risk management with what we consider best practice in the financial services industry, a direct comparison with all the metrics used by regulated commercial entities can be misleading. The portfolios of ECAs will tend to have:

- a higher risk profile
- a strong focus on emerging market risks
- longer risk horizons
- greater risk concentrations

### Credit risk governance

The ultimate responsibility for credit risk management within UKEF lies with the Chief Executive who, as Accounting Officer, is answerable to ministers and Parliament for all aspects of the department's operations. With regard to credit risk, the Chief Executive is supported by a number of committees (principally the Credit Committee) and UKEF's risk management activities are further subject to independent monitoring and scrutiny.

The UKEF Board provides independent advice, scrutiny and challenge to the Chief Executive across a broad range of areas, including risk management, while its Risk Committee separately reviews the adequacy of risk management and controls across the department.

HMT officials monitor the department's performance against its financial objectives. While UK Government Investments (UKGI) does not have any executive powers over UKEF's operations, its officials review the department's risk management function and processes, to ensure that risk and internal controls are effectively managed. UKGI also provides advice to the Secretary of State on the exercise of ministerial responsibility for UKEF.

Within UKEF, the Credit Committee is responsible for advising the Chief Executive on the effective management of UKEF's credit risk exposures. Its responsibilities include:

- approving, managing and monitoring credit risk exposures at the transaction and portfolio level
- agreeing credit risk policies
- ensuring that credit risks are properly monitored, controlled and reported through UKEF's processes and systems

It is scheduled to meet fortnightly, and can be convened on an ad hoc basis to consider urgent business. The standing members of the Committee are:

1. Chief Executive Officer
2. Chief Risk Officer
3. Chief Financial Officer
4. Business Group Director
5. Deputy Director of Risk Assessment Division
6. Deputy Director of Country Risk and Analysis Division
7. Head of Pricing and Portfolio Risk Unit

The Head of Legal Division or a nominee will also attend to provide advice on legal matters.

5 This limit is expressed in special drawing rights (SDR), an international reserve asset created by the IMF.

For a meeting to take place, at least 3 standing members of the committee must be present. At least 1 of the following must attend every meeting:

- Chief Risk Officer
- Deputy Director of Risk Assessment Division
- Deputy Director of Country Risk and Analysis Division

Further, either the Chief Executive or Chief Financial Officer must also attend every meeting. In the absence of the Chief Executive, a unanimous decision of standing members, including the Chief Financial Officer, must be obtained for any approvals.

## Financial objectives and appetite

UKEF's financial objectives, set by HMT, are designed to enable it to fulfil its mandate of supporting exporters while ensuring that credit risk and pricing a) is undertaken on a basis that returns adequate rewards to UKEF for the risks it is assuming; and b) does not expose the taxpayer to the risk of excessive loss.

UKEF's credit risk and pricing is governed by five financial measures:

1. **Maximum commitment:** the total amount of nominal credit risk exposure that the department may incur. Set at £50 billion but adjusted for foreign exchange movements (for example, at 31 March 2018 the adjusted maximum commitment was £57.3 billion)
2. **Risk appetite limit**: a form of economic capital limit of £5 billion (detailed further in the next section)
3. **The Exposure Management Framework (EMF):** a limit to exposure of £5 billion for the lowest risk markets, with reducing capacity as the risk profile increases (detailed further in Exposure Management Framework on page 44)
4. **Reserve Index:** an index that measures whether UKEF has accumulated, over time, sufficient revenue to cover its possible credit losses at the 77.5 percentile on our 10-year loss distribution[6]
5. **Pricing Adequacy Index and Premium to Risk Ratio:** detailed under Pricing policies on page 49

The 2017-18 outturn against all our financial objectives is presented on page 23.

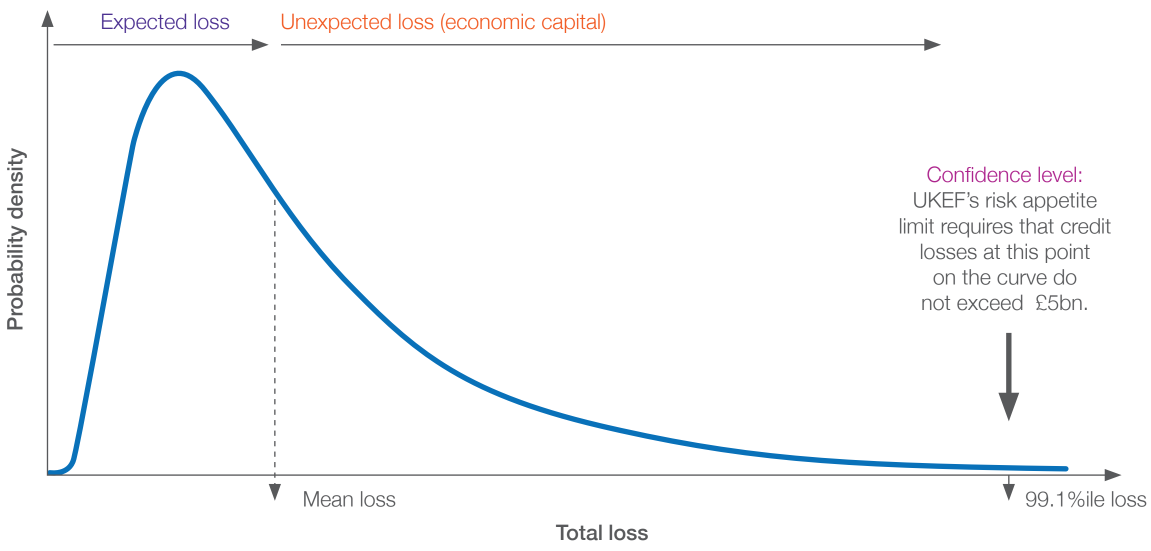
Real-time market data from Bloomberg is used by the Country Risk team

6 The reserve index means the ratio of (a) cumulative reserves plus associated provisions to (b) the aggregate of the value of the 77.5 percentile point on UKEF's 10-year loss distribution plus provisions. At the end of each month, the index must be at least 1.

## Economic capital and the risk appetite limit

Economic capital (often referred to as capital at risk or CaR) is a measure of risk, based on potential future losses. It can be considered as a buffer to cover unexpected losses over a defined future period at a specified confidence level. The chart below illustrates this concept for a hypothetical portfolio of credit risks.

### Portfolio loss distribution




**Expected loss** is the anticipated average loss over a defined time period. Expected losses essentially represent a 'cost of doing business', implying that when a financial institution assumes credit risk, it should always seek to charge an amount at least sufficient to cover the expected loss associated with the relevant loan, guarantee or insurance policy.

The **confidence level** (in a private sector context) can be viewed as the risk of insolvency over the defined time horizon. The higher the confidence level selected, the lower the probability of insolvency. Through the risk appetite limit, HMT has set a 99.1% confidence level for UKEF over a 10-year time horizon. (This is a theoretical measure for risk management purposes, as if UKEF did incur losses, these would be ultimately underwritten by public funds.)

**Unexpected loss** accounts for the potential for actual losses to exceed expected losses, reflecting the uncertainty inherent in the estimate of future losses. Calculations of unexpected loss will tend to increase if a portfolio has high risk concentrations and/or the risks in the portfolio are strongly correlated. UKEF defines unexpected loss as the difference between the portfolio expected loss and the 99.1% value of the loss distribution. (Other financial institutions often consider this to be their economic capital requirement.)

The risk appetite limit set by HMT means that UKEF must manage its credit risk-taking activities such that total losses, as modelled by our portfolio risk management simulation model using a 10-year time horizon, will not (with a 99.1% degree of certainty) exceed £5 billion (adjusted for foreign exchange movements). In other words, at no time should portfolio expected loss, plus provisions against claims already paid, plus portfolio unexpected loss, exceed £5 billion (adjusted for foreign exchange movements).

The credit risk policy, the pricing methodology and the exposure management framework are the main policies that apply to the management of credit risk within UKEF. All policies are reviewed at least annually by the Credit Committee and endorsed by the Risk Committee.

## Credit risk policy

This sets out the high-level policies and processes used for assessing, measuring, managing and reporting all categories of credit risk to which UKEF is exposed. It establishes minimum risk standards and ratings-based exposure review points.[7] A series of more detailed risk management policies, frameworks and individual risk methodologies sit underneath the credit risk policy.

## Pricing methodology

This sets out the methods and parameters used for setting premium rates for all product types, consistent with our policy objective of supporting UK exporter competitiveness, while ensuring that we meet our financial objectives and protect the taxpayer from loss. International agreements such as the OECD Arrangement on Officially Supported Export Credits (the OECD Arrangement)[8] and World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures also impose obligations in relation to the adequacy of risk-based pricing.

## Exposure management framework

We assume credit risk in many countries as we support UK export transactions. Our exposure management framework sets individual country limits based on the following key principles:

- countries with higher levels of credit risk, based on individual country reviews on a ratings-based approach, will have lower limits
- the larger a country's economy (as measured by its GDP), the higher the country limit
- country limits should be set relative to the notional financial resources available to UKEF and consistent with UKEF meeting its financial objectives
- the upper boundary for exposure to any individual country is £5 billion

The Credit Committee regularly reviews UKEF's country limits and cover policy. In addition, they set individual controls on a case-by-case basis within each country limit. Risk and cover policy must be assessed and decided for around 200 markets, but priority is given to active new business requirements and existing exposures.

## Country risk assessment

We assess each country in which we have an actual or potential credit exposure and use this to produce a credit rating, from AAA (highest) to D (default, lowest). Our risk assessment framework is aligned with that used by Standard & Poor's (S&P), but is additionally informed by cross-Whitehall forums, local UK diplomatic representatives, quarterly OECD country risk expert meetings, and country visits, where appropriate.

Where no external credit rating exists, we typically derive our final letter rating from a World Bank shadow-rating model supplemented by analyst judgement and peer comparisons.

## Corporate, bank and project finance risk assessment

Risk assessments for the majority of our medium to long-term credit exposure to overseas corporates and banks are principally based on S&P methodologies. We use a number of their credit rating templates to cover our principal areas of business (general corporates, airlines, banks and project finance). These are annually updated and approved by the Credit Committee.

The rapid expansion of our trade finance business, which typically involves small and medium-sized enterprises (SMEs) and relatively small individual credit risk exposures, has led us to purpose-build a number of credit assessment methodologies with shorter turnaround times for certain categories of risk. For example, a specific credit assessment and approval process has been adopted for our bond support and export working capital facilities, under which UKEF shares risks with financial institutions for the provision of working capital loans and on-demand contract bonds in support of export transactions. This process was further enhanced in 2017-18 as we agreed greater delegated authority for financial institutions to apply our guarantee more quickly and flexibly within agreed eligibility criteria (see page 31).

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7 The only time when UKEF's internal risk policies might not apply would be if ministers (having regard to the national interest) gave a written direction to the Accounting Officer requiring a specific credit risk to be underwritten. In these circumstances, the credit risk in question would be handled differently, and accounted for under Account 3.

8 The OECD Arrangement, sometimes referred to as 'the Consensus', limits self-defeating competition on export credits among members of the OECD. OECD members undertake to operate within these guidelines when providing official support for export credits of two years or more.

Similarly, a bespoke credit assessment process has been developed to handle the payment risks that arise under our export insurance, and the credit and political risks covered by our bond insurance.

## UKEF's credit risk methodologies

| Product category | Product | Description | Credit risk party | Credit risk methodology |
|---|---|---|---|---|
| **Credit insurance** | Export insurance policy | Covers risk of non-payment under an export contract due to specified commercial and political risks | Overseas buyer | Bespoke UKEF methodology |
| | Bond insurance policy | Covers unfair calling of contract bonds, or fair calling due to specified political events | Overseas buyer | Bespoke UKEF methodology |
| **Loan/capital market guarantees** | Buyer credit facility | Guarantees medium/long-term finance from lenders or capital market investors provided to overseas buyers of UK goods/services | Overseas buyer | Bespoke UKEF methodology |
| | Supplier credit facility | | | |
| | Lines of credit | | | |
| | Export refinancing facility | A buyer credit provided with an undertaking to support refinancing of the bank loan through the capital markets | Overseas buyer | |
| **Trade finance** | Bond support scheme | Guarantees contract bonds provided by private lenders | UK exporter | Bespoke UKEF methodology |
| | Export working capital scheme | Guarantees working capital loans provided by private lenders to UK exporters | UK exporter | Bespoke UKEF methodology |
| | Letter of credit guarantee scheme | Guarantees for banks that confirm letters of credit issued in favour of UK exporters | Overseas issuing bank | S&P bank rating methodology |
| **Lending** | Direct lending facility | Medium/long-term loans from UKEF to overseas buyers of UK goods/services | Overseas buyer | Bespoke UKEF country risk methodology S&P rating methodologies |
| **Investment insurance** | Overseas investment insurance | Insures overseas assets of UK exporters against specified political risks | Overseas buyer and its sovereign | Bespoke UKEF methodology |

UKEF continues to have residual credit exposure to a small number of 'investment grade' banks that act as counterparties in interest rate swaps, entered into by UKEF to hedge interest rate exposure under its legacy fixed-rate export financing scheme, which closed to new business in 2011 (see page 58). UKEF has the right to terminate these trades if a counterparty's rating falls below a specified threshold.

## Credit risk assessment outputs

Expected loss is a key measure of credit risk at UKEF, and is central to our pricing methodologies and our underwriting fund accounting.[9] Our credit risk assessments are used to indicate the three components of expected loss:

Probability of default X Loss given default X Exposure at default = Expected loss

Credit risk assessments are used to assign a rating (from AAA to D) to all credit risks within UKEF, each with an associated probability of default. The probabilities are updated at least annually in line with the latest S&P statistics.

Our credit risk assessments also provide an estimate of loss given default: how much we stand to lose if an obligor defaults, expressed as a percentage. Corporate loss given default assessments are conducted on a case-by-case basis, considering the specifics of the transaction in question, including security, priority ranking, and likelihood of restructuring, sale or liquidation. In the absence of a bespoke calculation, UKEF's standard corporate loss given default assumption is 50%.

In the case of sovereign risk, persistence of default is also included in the calculation of potential loss. Based on empirical research, persistence of default (the predicted duration of a country's default) is calculated as a function of its per capita income, the severity of its indebtedness and whether the default is a liquidity event or an insolvency.

The third output of our assessments is exposure at default, meaning the credit risk exposure we have at the time of default.

The other measure of credit risk we monitor closely is unexpected loss, which is integral to our credit risk appetite (see 'Economic capital and the risk appetite limit' on page 43).

## Risk concentration and correlation

Given its role, it is almost inevitable that UKEF's credit portfolio will have risk concentrations. Consequently, portfolio modelling (particularly the impact on unexpected loss) plays an important role in deciding the maximum amount of credit exposure UKEF might assume on a single obligor, or group of related obligors.

For any given case, our modelling will seek to account for the likely correlations between all risks in the portfolio. Only if the Credit Committee is satisfied that a given level of credit exposure will not threaten any of the department's financial objectives in light of this modelling will it consider making a positive recommendation to the Chief Executive.

Portfolio modelling is only one of a number of measures in place to manage risk concentrations. In addition:

- all individual exposures within a country must not exceed the country limit, as established under our exposure management framework
- UKEF may not give a single commitment in excess of £200 million without the agreement of HMT
- the portfolio is further managed by way of review of single obligor, sector and regional/ geographic concentration risk

9 Expected loss applies both at an individual transaction level and at portfolio level. At a portfolio level, it is simply the sum of the expected losses of all risks in the portfolio and equates to the mean of the portfolio loss distribution.

One practical means of reducing risk concentration at the transaction initiation stage is through reinsurance or counter-guarantees from the market or, more normally, other ECAs. UKEF will often seek this when it is acting as lead ECA in a transaction where goods/services are sourced both from the UK and from other countries.

While UKEF has used credit default swaps (on a value-for-money basis) to manage large exposures in the past, more recently UKEF has approached the private insurance market, which can have appetite for risk-sharing on medium to long-term exposures, in such cases.

### Stress testing and scenario analysis

It is UKEF policy to undertake extensive stress testing of its credit portfolio. Stress testing assesses the impact of various adverse scenarios and is conducted every 6 months.

These scenarios are designed to reflect potential emerging risks and may vary from one exercise to the next but may include, for example, a general emerging markets crisis or an extended period of very low oil prices. They generally involve simulating:

- rating downgrades
- increases in loss given default
- a series of large individual defaults
- a combination of downside scenarios

The Credit Committee reviews the results of the analysis and considers in particular the impact of each stress/scenario on the value of the 99.1% point of the portfolio loss distribution, relative to the risk appetite of £5 billion.

UKEF uses its own portfolio risk management simulation model and its associated correlation matrices to undertake all portfolio-level credit risk modelling, and to produce portfolio loss distribution curves. The model is also used to simulate the extent and timing of potential gross cash outflows as a result of claims payments. This analysis is valuable for informing cashflow forecasts and for liquidity management purposes.


Baroness Fairhead, Minister of State for Trade and Export Promotion, has Ministerial responsibility for UK Export Finance

## Pricing policies

### Context

On the principle of maintaining a 'level playing field', the OECD Arrangement requires ECAs to charge risk-based premiums that are sufficient to cover their long-term operating costs and credit losses. This mirrors the provisions of the WTO Agreement on Subsidies and Countervailing Measures, which classifies export credit guarantee programmes that do not cover their long-term operating costs and losses as 'prohibited subsidies'.

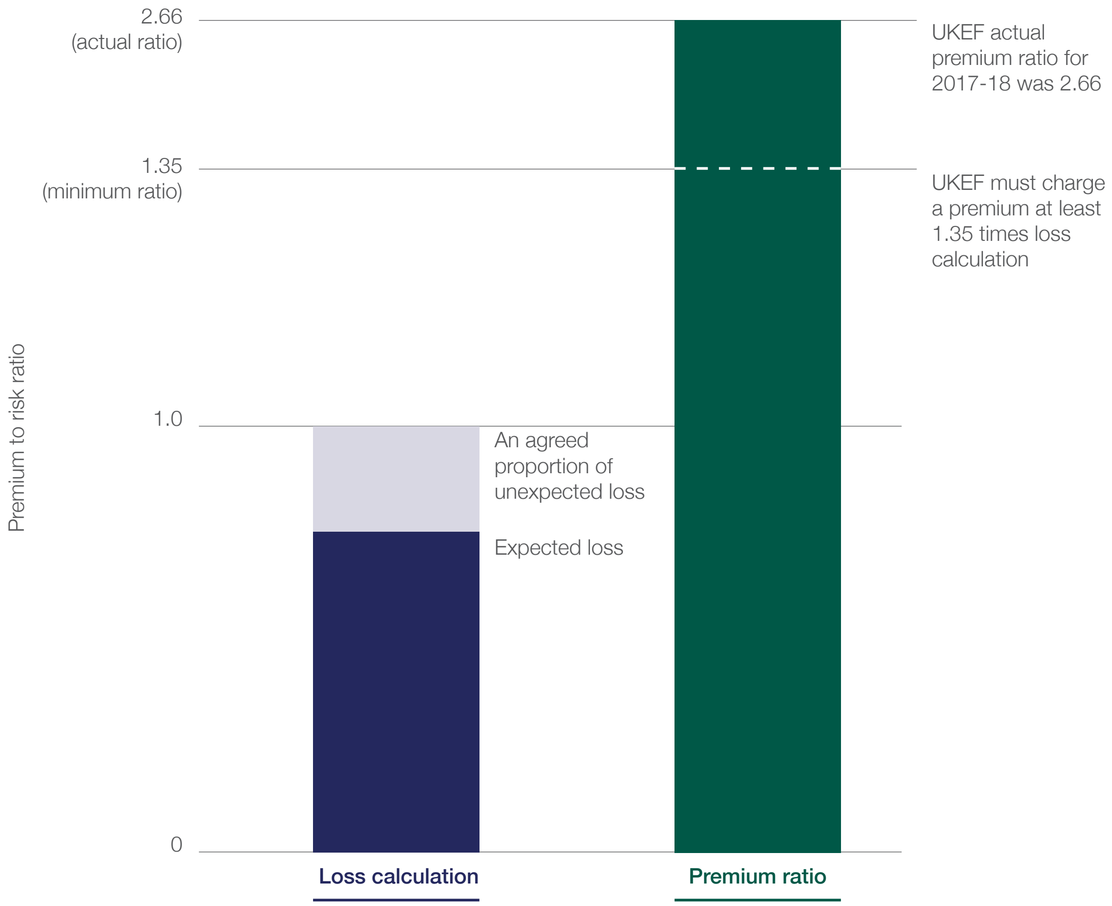
### Financial objectives

Consistent with these principles, HMT has set UKEF 2 financial objectives designed to ensure, as far as possible, that the premium rates we charge reflect the risk taken on, and are sufficient for us to operate at no net cost to the taxpayer over time.

### Premium-to-risk ratio

Firstly, the premium-to-risk ratio states that each month we must demonstrate that the premium charged on the business issued, or forecast to be issued in the financial year, will be 1.35 times greater than an agreed level of possible losses corresponding to those transactions as measured at the time of pricing.

The ratio at 31 March 2018 was 2.66 against the 1.35 ratio minimum:

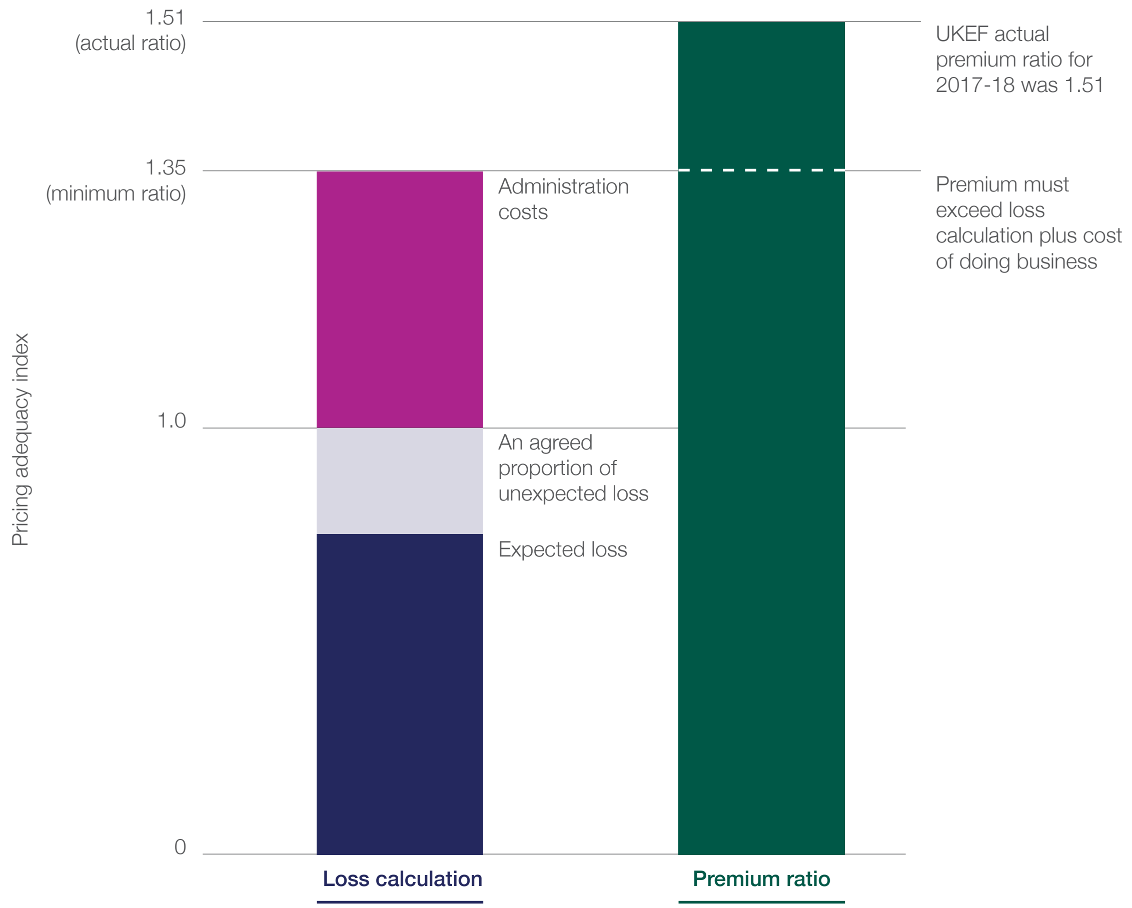


## Pricing adequacy index

The second objective set out by HMT is the pricing adequacy index. Whereas the premium-to-risk ratio serves purely as an annual measure, the pricing adequacy index considers a 3-year time scale, applied across 3 accounting periods:

- the 2 previous and the present financial year
- the previous, current and next financial years
- the present and the next 2 financial years

For each period, UKEF must demonstrate that the actual/forecast premium will cover and exceed the ‘cost of doing business’, meaning administration costs and an agreed level of possible losses. The ratio for the past 2 years and present financial year was 1.51 against the minimum of 1.0.




## Forecasting approach

Business and premium forecasts are based on the judgements of our underwriters who draw on available transaction pipeline information, market intelligence and the estimated likelihood of transactions materialising within the current or future financial years. In addition, we perform regular sensitivity analysis to supplement these ‘central’ forecasts and to test the robustness of forecast financial performance against the agreed premium-to-risk ratio and pricing adequacy index targets.

## Pricing methodology

We set risk-based premium rates for all of our products using pricing methodologies and parameters that are reviewed annually by the Credit Committee, endorsed by Risk Committee and agreed by HMT.

UKEF aims to support UK exporter competitiveness. It is therefore our policy that we set the lowest tenable premium rates, subject to the following:

- premium rates may not undercut the minimum rates set out in the OECD
- no individual premium can be below the expected loss of the associated transaction
- aggregate premiums must satisfy the premium-to-risk ratio and pricing adequacy index objectives
- as it is UKEF's policy to complement not compete with private finance support, premium rates set for OECD markets without fixed benchmarks (Category 0/'rich' markets) should not undercut available market pricing[10]
- premium rates must comply with our international obligations, including EU state aid legislation

In practice, the vast majority of medium and long-term transactions are priced at the minimum rate permitted under the OECD Arrangement.

## Organisational model and accountabilities

UKEF has a functional organisation structure, with the business origination teams separated from the risk, financial control and reporting functions. This basic internal control is designed to avoid conflicts of interest and to provide vital and appropriate checks and balances in the credit approval and credit management processes.

Within the Credit Risk Group, there is a framework of delegated credit authorities:

- the Chief Risk Officer has been given authority by the Chief Executive to approve various categories of credit risk within pre-determined limits
- in turn, the Chief Risk Officer has granted authority over certain credit approvals to senior staff within his team
- credit approvals that exceed the delegated authority of the Chief Risk Officer must be approved by the Credit Committee

## Credit processes and reporting

All material credit risks must be approved by the Credit Committee or a designated member of the Credit Risk Group with the appropriate delegated authority. Once approved, credit exposures are continuously monitored and reviewed at both portfolio and individual transaction level.

The Credit Committee oversees portfolio-level monitoring. This includes stress testing and scenario analysis every six months, and a monthly review of portfolio movements, particularly focusing on exposure, expected loss and unexpected loss changes. Monthly management information reports the performance of the credit portfolio against our financial objectives. We also monitor monthly whether exposure is within the agreed country and other limits.

At a transactional level, we regularly update the ratings allocated to countries and individual obligors and, where applicable, confirm compliance with financial covenants contained in loan agreements upon receipt of relevant audited accounts. UKEF maintains 'watch lists' of obligors whose credit risk is deteriorating; if the credit of a non-sovereign borrower deteriorates such that UKEF might expect to pay out under a guarantee or insurance policy, the case will be managed by a dedicated claims and recoveries unit.

## The claims and recoveries unit

The claims and recoveries unit submits regular reports to the Credit Committee on all accounts it is responsible for and seeks approval for its recovery actions. Once a claim has been paid, the unit makes provisioning recommendations to the Credit Committee on a case-by-case basis, with a full provisioning exercise conducted at the end of each financial year.

10 In the last year, the OECD has agreed new minimum premium rate rules for these markets to ensure consistency in pricing among participating ECAs.

Sovereign defaults that lead to debt renegotiations through the Paris Club[11] are managed by a team within the Chief Operating Officer's Group that specialises in rescheduling, working in conjunction with HMT. Paris Club developments are monitored by the Credit Committee, which must approve any provisions made against this exposure.

The process of recovery through Paris Club rescheduling is often a protracted one: a number of still-active reschedulings relate to exposure principally incurred prior to April 1991.

## Credit risk performance 2017-18

### Context

Our credit portfolio is dominated by long-dated emerging market risk, consistent with our role as the UK's official export credit agency. We are limited in our control over the geographic or sectoral composition of our portfolio, as we assume credit exposure in line with the needs of UK exporters rather than through the pursuit of a well-balanced portfolio.

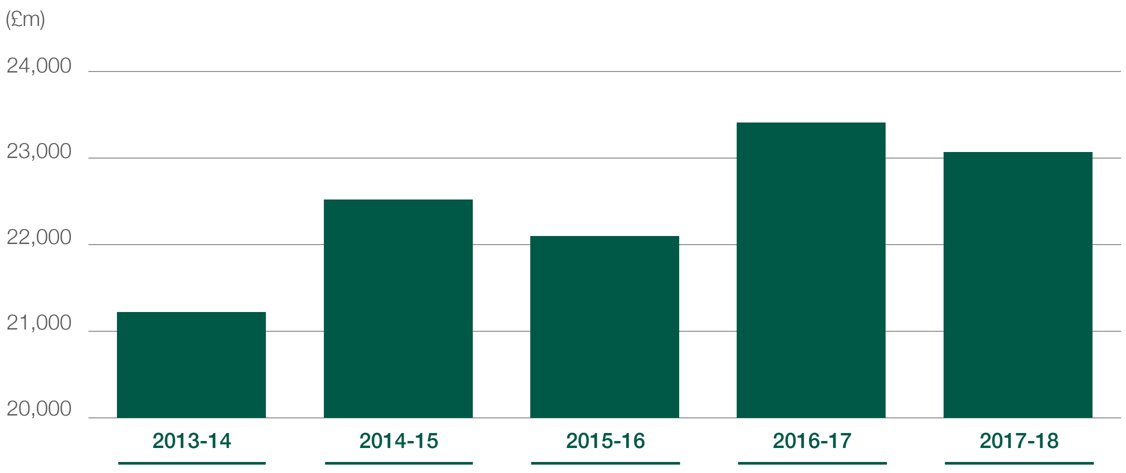
In portfolio terms, exposure to SMEs in the UK, taken on a risk-shared basis with financial institutions, is relatively low and remains broadly stable due to the typically small transaction size, but may increase in the future as new exporters are supported including through a proactive awareness campaign in accordance with the department's Business Plan.

In 2017-18, we again demonstrated full compliance with all our financial objectives relevant to the credit portfolio. A full summary of performance against financial objectives is reported on page 23.

### The UKEF credit risk portfolio: 12-month summary

- Total exposure including commitments and legacy Account 1 exposure decreased from £23.4 billion to £23.1 billion – a reduction due to foreign exchange movements and run-offs exceeding new business written
- UKEF's portfolio of risks remained stable in terms of credit quality, while regional and sector concentrations increased in the Middle East and oil, petrochemicals and construction sectors. However, these exposures remain modest relative to the maximum commitment limit and risk appetite limit
- Stress testing (including to oil price shocks) shows that UKEF's portfolio remains resilient and should continue to meet its financial objectives even in a number of extreme economic scenarios
- Country risk capacity increased in a further 115 countries to enable UKEF to meet the increased demand shown by a larger pipeline, and consistent with robust assessments made under the exposure management framework
- Stable expected and unexpected loss rates with a continuing very low rate of claims paid at £2.4 million (of which £1.6 million were for new defaults this year)

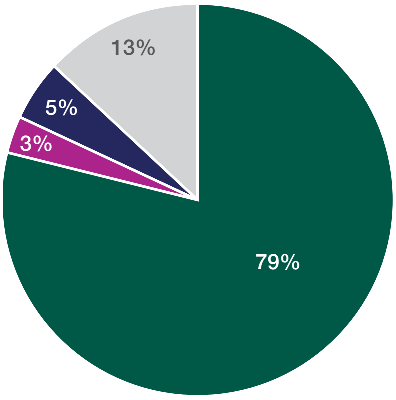
### Credit risk exposure



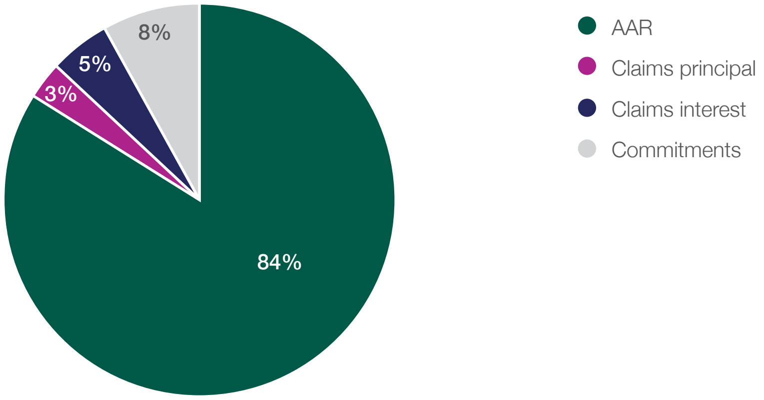

11 The Paris Club is the informal group of official creditors that seeks to establish coordinated and sustainable solutions to debt service difficulties experienced by debtor countries.

The charts below show the breakdown of this exposure between amount at risk (AAR), claims (principal and interest) and commitments.[12]

**Breakdown of total exposure 31 March 2018**

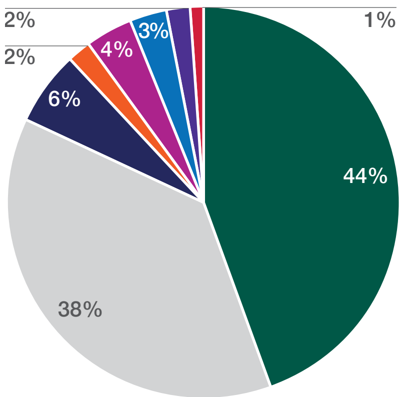



**Breakdown of total exposure 31 March 2017**

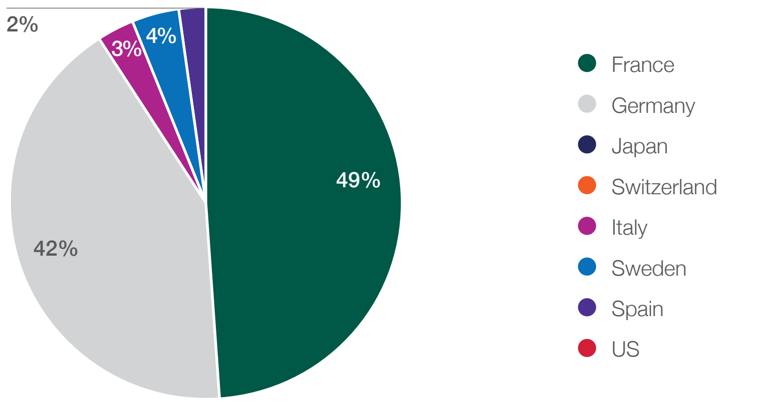



At 31 March 2018, total AAR amounted to £18.2 billion (£19.5 billion in 2017). This figure includes £4.7 billion of counter-guarantees provided to UKEF by other European ECAs (£5.5 billion in 2017), principally related to Airbus business, and £0.4 billion of private reinsurance used to manage risk concentrations in our portfolio (in both years).

**Breakdown of export credit agency counter-guarantees 31 March 2018**




**Breakdown of export credit agency counter-guarantees 31 March 2017**



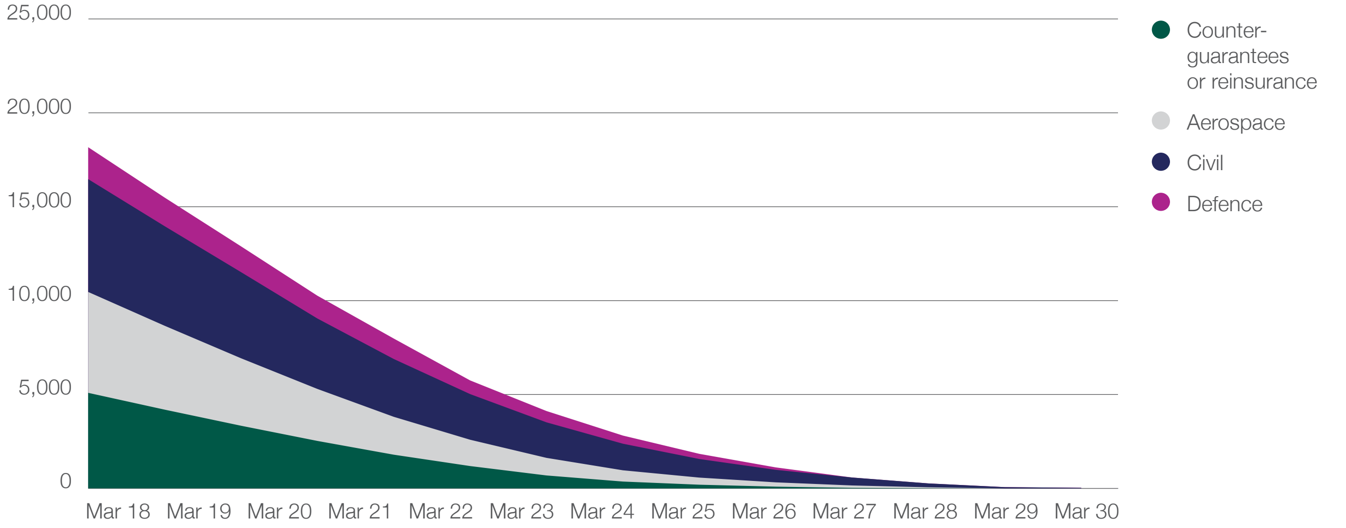

12 Commitments are cases not yet the subject of an issued and effective guarantee, but for which UKEF has communicated its intention, before a specified date and subject to conditions, to provide support.

## Horizon of risk

The vast majority of our credit exposure is made up by medium to long-term finance. The chart below illustrates how our current portfolio is expected to run off over time in terms of overall AAR. Over the next 12 months around 15% will run off, with around 56% of the current portfolio expiring within 4 years.

### Amount at risk run-off

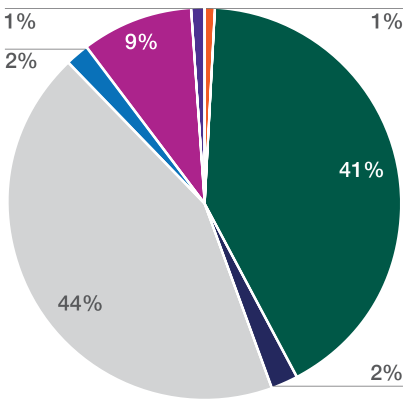
(£m)



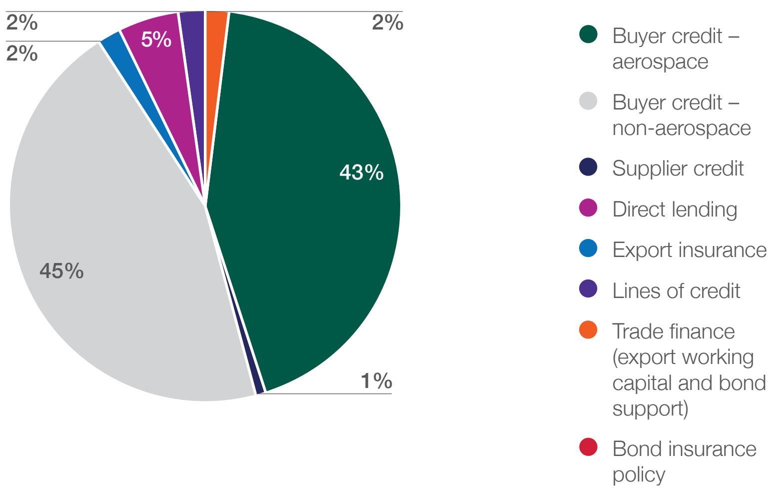

## Exposure by product

The charts below break down the AAR by product sector, excluding ECA and private market reinsurance. Overall the portfolio is stable across UKEF's product range, with new business being largely balanced against run-off and a weakening $/£ exchange since the previous year end. Direct lending continues to increase as a proportion of overall exposure.

### Exposure by product 31 March 2018




### Exposure by product 31 March 2017

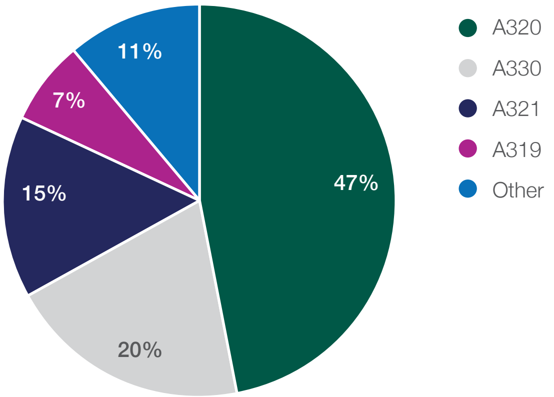


## Risk concentrations

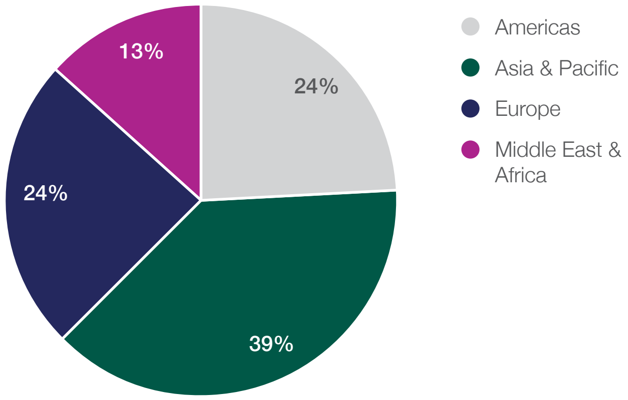
### Sectors

UKEF's largest risk concentration remains in aerospace, accounting for 41% of the AAR (net of export credit agency reinsurance/counter-guarantees) as at 31 March 2018 (42% for 2017). However, our aerospace portfolio is well diversified across airlines and aircraft-leasing companies, aircraft type and geographical region, detailed below. Actual exposure is down given run-offs and reduced levels of new business written this financial year.

**Aerospace portfolio by aircraft type**
(measured by number of aircraft)




**Aerospace portfolio by aircraft geography**
(measured by number of aircraft)




The majority of aerospace exposure is secured on the underlying aircraft.[13]

Accounting for the value of this asset security, UKEF's net exposure to the sector is slightly lower than last year, at £229 million (£249 million in 2017).

At 31 March 2017, UKEF had £1.5 billion credit exposure to the oil and gas sector, representing 12% of our overall AAR (net of export credit agency reinsurance/counter-guarantees). This was mainly attributed to major emerging market oil companies in Asia and South America.

Other sector concentrations were to the chemicals industry (£1.2 billion AAR), spread across the Middle East and Asia, and commercial real estate (£2.3 billion AAR), mainly in the Middle East. There is a pipeline of new business in both the oil and gas and petrochemical sectors given the strong credentials of UK exporters in these areas and UKEF's proactive approach to enhancing UK content and the number of UK exporters in the projects it supports.

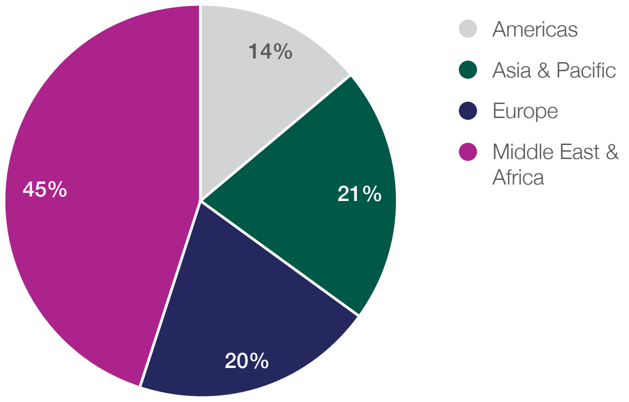
13 This means that UKEF can take possession of aircraft from defaulting airlines. Following the 9/11 terrorist attacks, we took possession of, leased and eventually sold 44 aircraft, ensuring losses both to the airline industry and UK taxpayer were minimised during this difficult period.

## Geography

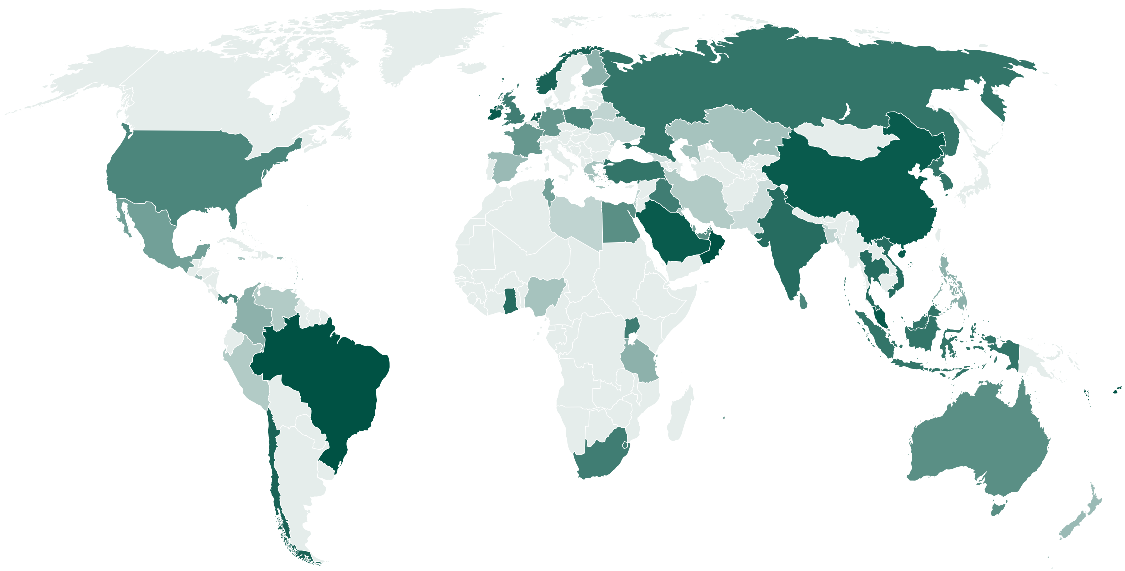
As of 31 March 2018, the Middle East and Africa accounted for 45% of our net AAR portfolio. The majority of this resulted from support of UK exports to Dubai, Saudi Arabia, Oman and Abu Dhabi.

Asia accounted for 21% of net AAR, with around £1.9 billion attributable to civil aerospace business with a number of airlines. In the Americas, around £0.6 billion of exposure was attributable to the aerospace sector, and the remaining exposure largely centred on Brazil.

### Regional breakdown of net AAR - whole portfolio




### Global AAR at 31 March 2018

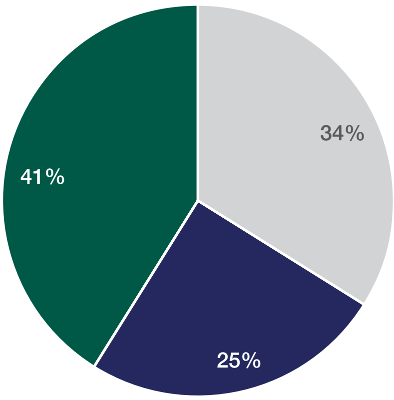


Darker shading indicates higher AAR

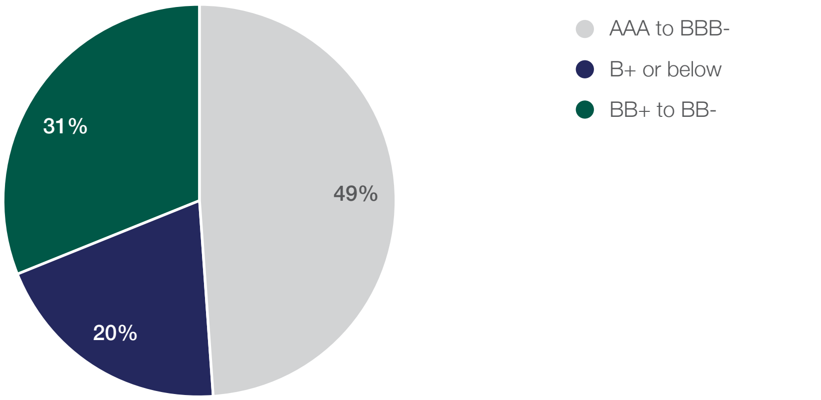
## Credit quality

The credit risk quality of our portfolio remained stable in 2017-18. As at 31 March 2018 34% of AAR (net of reinsurance) was rated 'investment grade' by UKEF (compared to 49% in 2017). Rather than reflecting a migration in risk appetite, the decrease in the 'investment grade' (AAA to BBB-) segment was primarily due to rating downgrades in relation to a few substantial transactions while the increase in the B+ and below segment relates to new business issued in the year.

**Net AAR by rating 31 March 2018**



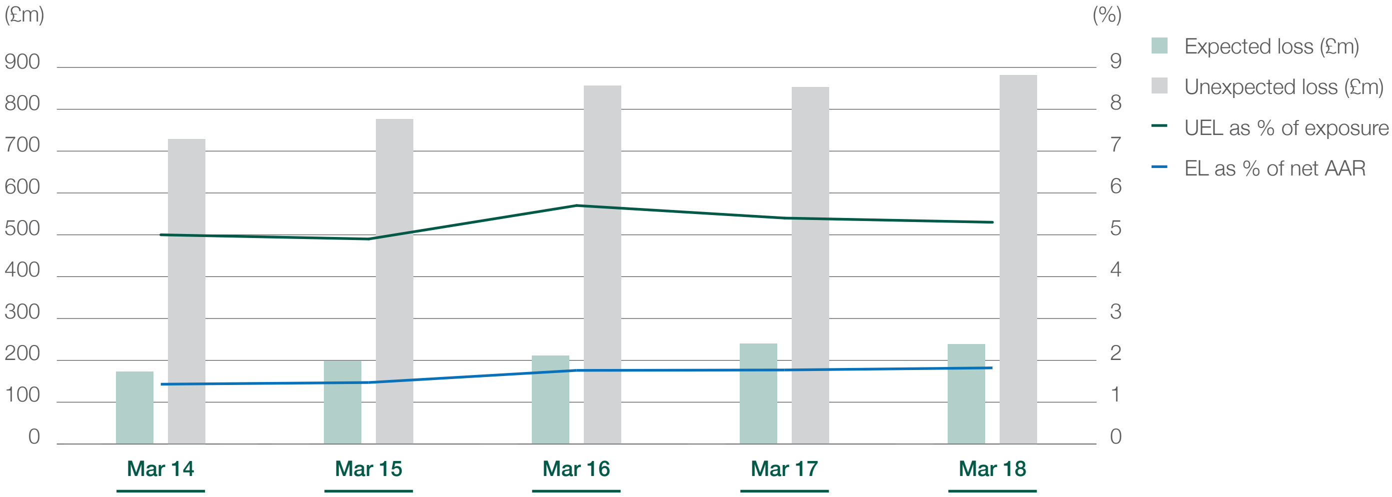

**Net AAR by rating 31 March 2017**




Portfolio expected loss decreased slightly, consistent with a reduced AAR, from £240 million to £238 million, representing 1.8% of net AAR, as it was in 2017.

Portfolio unexpected loss increased slightly to £882 million as of 31 March 2018, from £853 million in 2017, representing 5.3% of net AAR (5.4% in 2017).

### Expected loss and unexpected loss trend




## New claims paid in the year

UKEF continued to experience very low levels of claims paid. The low level of new claims is informed by rigorous credit risk assessments, good underwriting and structuring of transactions, and risk management standards more generally, all helped by a largely benign credit environment globally.

There have been fewer defaults affecting the short-term EXIP portfolio than expected, given the majority of transactions are in challenging countries, but exposure to this product is relatively modest. Similarly, the predominantly UK SME portfolio supported under the bond support or working capital schemes has proved to be robust, with minimal losses since the schemes were introduced in 2011. This partly reflects the high proportion of bonding facilities which are intrinsically less risky, but also the well-established nature of our SME clients and their relationships with their banks, with which UKEF shares risk under these schemes.

For claims in 2017-18, we paid a total of £2.4 million (down from £8.4 million in 2016–17).

- Of this, £1.6 million represented claims payments made in respect of new defaults in the year.
- The new claims pertained to buyers defaulting in Azerbaijan and Costa Rica.
- The remaining balance was attributable to defaulting counterparties occurring in earlier years.

## Outstanding claims paid and provisions

The bulk of outstanding claims paid and still to be recovered by UKEF arose on business issued and defaulting prior to 1991. Almost all of the £1.46 billion (down from £1.54 billion in 2017) of outstanding claims paid on this business refers to sovereign exposure that is subject to Paris Club rescheduling, the most significant part of which is for Sudan (including a substantial amount due to accrued interest). The overall provision amount for this business decreased slightly on 31 March 2018 to £1.15 billion (down from £1.18 billion in 2017), mainly due to scheduled repayments.

Outstanding claims paid on Account 2 from business issued after 1991 has reduced slightly in the year, at £377 million at 31 March 2018 (down from £414 million in 2017), in line with scheduled Paris Club repayments overtaking increases in accrued interest. Sovereign exposure in Zimbabwe and Indonesia (the latter rescheduled at the Paris Club and performing in accordance with the agreed rescheduling) makes up the majority of this. Historical aerospace claims are also paying down in accordance with agreed rescheduling.

## Recoveries

Overall recoveries (on all business, both principal and interest) amounted to £103 million as at 31 March 2018 (£150 million in 2016–17), reducing total recoverable claims (excluding interest on unrecovered claims) to £701 million (£800 million in 2016-17). The majority of recoveries (£80 million) were made through the Paris Club and related to historical sovereign debt reschedulings. Recoveries from a number of corporate names made up the balance.

## Risk appetite limit

Consistent with a stable portfolio in terms of exposure and business mix the projected portfolio loss to the 99.1%ile remained steady at £1.4 billion against a financial objective limit of £5 billion set by HMT.

## Portfolio stress testing

The portfolio of business issued since 1991 is subject to regular stress testing and scenario analysis. The portfolio's sensitivity to changes in ratings and recovery rates is detailed below. None of the movements in the projected portfolio loss to the 99.1%ile shown above would cause a breach of our risk appetite limit.

**Portfolio stress tests** (based on end of March 2018 portfolio)[14]

| (£m) | Across the board ratings downgrade | Reduced recovery rates | Ratings downgrade and reduced recovery rates |
|---|---|---|---|
| | 2 notches | - 20% | 2 notches & -20% |
| **Increase in expected loss** | 245 | 83 | 415 |
| **Increase in projected portfolio loss to the 99.1%ile point** | 393 | 271 | 956 |

14 This stress test is based on the complete UKEF portfolio. The corresponding sensitivity analysis presented in note 20 of the accounts is based on a portfolio confined to insurance contracts only, as defined by our accounting policies.

## Market risk management

### Context

Market risk is the risk of losses arising from movements in market prices. For UKEF, this arises from changes in interest rates and foreign exchange rates.

UKEF's principal exposure to interest rate movements is through its legacy fixed-rate export finance scheme, which was closed to new business in 2011.

Foreign currency risk arises from two main areas:

- Transaction risk: For UKEF, this is the risk of changes in the value of foreign currency interest receipts on conversion into sterling.
- Translation risk: This is the risk that UKEF's statement of financial position and net operating income will be adversely affected by changes in the sterling value of assets denominated in foreign currency, and by liabilities from movements in foreign currency exchange rates.

### Interest rate risk

#### Fixed rate export finance (FREF) scheme

Until 2011, UKEF operated a fixed rate export finance scheme, under which it supported medium and long-term fixed-rate lending by commercial banks at internationally agreed 'commercial interest reference rates' (CIRRs) to overseas borrowers.

The lending banks funded the loans at floating rates (LIBOR plus a margin). Through 'interest make-up' arrangements, UKEF made up the difference when the lender's floating rate was more than the applicable CIRR. When the floating rate was less than the applicable CIRR, the lender paid UKEF the difference. This system exposed UKEF to interest rate risk.

Before closing the scheme in 2011, UKEF pursued an active interest rate hedging policy, eliminating, as far as possible, its exposure to interest rate risk via a portfolio of matching interest rate swaps. These interest rate swaps remain in place, reducing in line with the amortising profile of the loans themselves.

HMT no longer applies a quantitative financial objective addressing this legacy portfolio. Also, given the substantially matched position of the interest make-up arrangements and the interest rate swaps, no new hedging activity has been undertaken since 2011, nor is planned for the future.

Internal policies in relation to active hedging have been discontinued. Nevertheless, we monitor the financial position of the scheme and its residual interest rate risk closely.

The portfolio is valued on a daily basis with its profit and loss performance measured against a series of internal limits. Movements in excess of these limits are immediately reported to the Chief Financial Officer and the Credit Committee for appropriate action.

These arrangements, along with several other reporting provisions relating to the scheme, are approved annually by the Credit Committee. Periodic sensitivity analysis is carried out on the portfolio to gauge the financial impact of interest rate movements on UKEF.

Due to portfolio run-off, the amounts involved in the FREF scheme are immaterial. Note 20 to the accounts includes details of the remaining maturity profile of the portfolio and the portfolio's sensitivity to movements in interest rates. Final run-off will occur in 2022-23.

#### Direct lending

In 2014, UKEF introduced a direct lending facility. This provides loans to buyers of UK goods and services at CIRR. UKEF is not charged interest by HMT on the funding provided to it for making these fixed-rate direct loans. Consequently, movements in interest rates during the life of the loans do not affect the financial performance of our direct lending activities.

To ensure that interest earned on each CIRR-based direct loan adequately covers the government's borrowing costs, a check is made prior to commitment that confirms that the sterling CIRR applicable to the direct loan is higher than the corresponding National Loans Fund rate.

If this is not the case, then interest on the direct loan will be charged at the higher rate. A similar arrangement, involving an interest rate check based on cross-currency swap methodologies, applies where direct loans are denominated in eligible foreign currencies.

## Foreign currency risk

### Translation risk

A material proportion of our guarantees and insurance policies are written in foreign currencies (usually USD). This exposes us to foreign currency risk, and associated volatility, in our financial results. The most significant year-on-year fluctuations in financial performance (evidenced by net foreign exchange gains/ losses in the statement of CNI) stem from the currency movements applicable to our non-sterling insurance assets (recoverable claims).

HMT does not permit UKEF to manage its foreign currency exposures, so no active hedging is undertaken. This is based on a number of HMT considerations such as:

- Our foreign currency assets and liabilities generally have long tenors such that the transaction risks can extend long into the future, and the timing and size of the amounts needing to be converted are uncertain, which could well make for expensive hedging arrangements.
- Our balance sheet provides some natural hedging of translation risk, and foreign exchange hedging is not straightforward and would require some specialist skills to operate it, adding to our operating costs.

Currency movements also have an impact on the sterling value of our contingent liabilities (principally guarantees and insurance policies). These movements can cause significant fluctuations in the sterling value of the department's AAR and, consequently, overall credit risk exposure. Since our maximum commitment and risk appetite limit (as financial objectives set by HMT) are adjusted for movements in US dollar/sterling exchange rates, we are afforded a degree of protection from adverse currency movements in meeting these two key financial objectives.

### Direct lending

Direct lending in currencies other than sterling is likely to increase foreign currency risk for UKEF. The lack of permission for UKEF to undertake foreign currency hedging applies equally to the department's direct lending activities. Accordingly, changes in the sterling value of direct loans as a result of foreign exchange rate movements will be reflected in the financial performance of our direct lending business.

## Liquidity risk management

Liquidity risk is the risk that a business, though solvent, either does not have the financial resources to meet its obligations as they fall due, or can only secure those resources at excessive cost. As a government department, UKEF can draw on the Exchequer to meet its financial obligations as they fall due if required.

The nature of some of UKEF's products means that significant payments could be required within a few days in the event of a default by an insured or guaranteed party. Arrangements to cover this eventuality have been pre-agreed with HMT. Regarding UKEF's direct lending activities, the requisite funding is provided by HMT. Note 20 of the accounts shows the scheduled maturity profile of UKEF's insurance contracts, expressed in terms of total AAR, and the dates at which the periods of risk expire.

Our exposure to foreign exchange movements has the potential to impact our ability to remain within the resources allocated to us by Parliament. Our voted control totals include headroom to mitigate this risk. However, between the last opportunity to adjust voted control totals in January and 31 March, there is a small risk that exchange rates could move and reduce our net income by more than the headroom agreed with HMT and voted for by Parliament. This would result in a breach of expenditure limits and require a vote to approve the excess.

# Chief Financial Officer's report

**Cameron Fox**
Chief Financial Officer

**This report summarises and highlights the department's financial performance for the year ended 31 March 2018. Given the importance of the management of UKEF's portfolio, this report should be read alongside the Credit risk, portfolio overview and pricing report. The detailed financial performance commentary (see below) for the year has been divided into operating segments (lines of business) and there is also a summary of UKEF's overall performance against resources voted by Parliament.**

## Overall results

UKEF achieved a net operating income of £5 million for the year ended 31 March 2018 compared with £149 million for the year ended 31 March 2017. The decrease in net operating income for the year was largely as a result of foreign exchange (FX) losses in 2017-18. UKEF reported a loss of £65 million for 2017-18 compared with a gain of £57 million in 2016-17. On an FX-adjusted basis the net operating income for 2017-18 was £70 million compared with £92 million for the year to 31 March 2017.

### Foreign exchange

As a significant proportion of UKEF's guarantees, insurance policies and loans are written in foreign currencies (mainly the US dollar), UKEF is exposed to foreign currency risk and associated volatility in terms of the financial results (UKEF is not authorised by HM Treasury (HMT) to hedge exchange rate exposures – see the Credit risk, portfolio overview and pricing report on page 40). During the year, Sterling appreciated by approximately 12% against the US dollar (see Note 20 of the financial statements which includes details of the currency profile of our insurance assets, financial instruments and capital loan commitments).

### Operating expenses

These were higher in 2017-18, at £34 million compared with £30 million in 2016-17. This increase was largely due to a planned increase in staff (see our people on page 89). UKEF however continued to deliver on a number of efficiencies related to our Spending Review 2015 saving commitments.

### Interest and claims credit

Over the course of 2017-18 there were a number of reductions in provision rates (less so than in 2016-17 however which accounts for the reduced claims credit) on a range of markets as well as the recovery of claims and interest on performing markets resulting in provision releases.

### Long-term assets and liabilities

Given the nature of the business that UKEF supports, the department has a significant holding of long term assets and liabilities.

UKEF's major asset, net recoverable claims (denominated in a range of currencies), decreased from £368 million in 2016-17 to £292 million during the year. Gross claims reduced from £0.8 billion to £0.7 billion as recoveries were made.

### Reserving for insurance liabilities

UKEF applies the fund basis of accounting (see the financial statements from page 111 for a fuller explanation) for its medium and long term business. At the end of the year the (net) underwriting funds stood at £629 million compared with £582 million at the end of 2016-17. Releases from the funds during the year (being business written in 2008 and 2014) was some £26 million in 2017-18. This release (which is a surplus of premium written over risk and costs of writing the business) reflects the quality of the underwriting and credit decisions made in 2008 and 2014.

## Accounts 1 to 5

UKEF operates 5 accounts (business segments): Accounts 1, 2 and 3 cover underwriting activities, while Accounts 4 and 5 cover activities in relation to the administration of refinanced loans and direct lending respectively.

- **Account 1** relates to guarantees and insurance issued for business prior to April 1991 and to insurance issued by UKEF's former Insurance Services Group (the main part of which was privatised on 1 December 1991).
- **Account 2** relates to the credit risk arising from guarantees and insurance policies issued for business since April 1991.
- **Account 3** relates to guarantees issued since April 1991, on the written instruction of ministers, that UKEF's Accounting Officer advised did not meet normal underwriting criteria.
- **Account 4** relates to the provision of support for Fixed Rate Export Finance (FREF) to banks (now closed for new business), together with arrangements for reducing the funding cost of FREF loans and for certain interest rate swap arrangements.
- **Account 5** relates to the provision of direct lending (since 2014).

A UKEF Board meeting. From left to right: Lawrence Weiss, Noel Harwerth, Shalini Khemka and John Hill

## Management commentary — 5-year summary

| | 2017-18 £m | 2016-17 £m | 2015-16 £m | 2014-15 £m | 2013-14 £m |
|---|---|---|---|---|---|
| **Overall value of guarantees and insurance policies:** | | | | | |
| New business supported – net of reinsurance | 1,865 | 2,178 | 1,507 | 2,685 | 2,272 |
| Amounts at risk – gross of reinsurance | 16,988 | 18,859 | 17,111 | 18,672 | 17,195 |
| **Statement of comprehensive net income:** | | | | | |
| Premium income net of reinsurance | 103 | 102 | 73 | 104 | 120 |
| Staff, other administration and operating costs | 34 | 30 | 30 | 31 | 26 |
| Foreign exchange gain/(loss) | (65) | 57 | 13 | 34 | (32) |
| Net operating income – total | **5** | **149** | **106** | **129** | **50** |
| Account 1 | 9 | 63 | 33 | 41 | 18 |
| Account 2 | 22 | 70 | 64 | 81 | 19 |
| Account 4 | 2 | 4 | 6 | 7 | 13 |
| Account 5 | (28) | 12 | 3 | - | - |
| Net operating income – foreign exchange adjusted | 70 | 92 | 93 | 95 | 82 |
| Statement of cash flows: | | | | | |
| Claims recoveries – total | **76** | **120** | **133** | **115** | **108** |
| Account 1 | 34 | 47 | 49 | 44 | 38 |
| Account 2 | 42 | 73 | 84 | 71 | 70 |
| Interest recoveries in the year – total | **27** | **31** | **28** | **25** | **27** |
| Account 1 | 26 | 28 | 24 | 22 | 23 |
| Account 2 | 1 | 3 | 4 | 3 | 4 |
| Claims paid – total | **2** | **8** | **5** | **6** | **13** |
| Account 2 | 2 | 8 | 5 | 6 | 13 |
| Net cash flow from operating activities – total | **225** | **272** | **199** | **237** | **205** |
| Account 1 | 60 | 74 | 73 | 65 | 59 |
| Account 2 | 114 | 158 | 109 | 165 | 138 |
| Account 4 | 2 | 3 | 5 | 6 | 8 |
| Account 5 | 49 | 37 | 12 | 1 | - |
| Statement of financial position: | | | | | |
| Recoverable claims before provisioning | **701** | **800** | **876** | **996** | **1,075** |
| Account 1 | 463 | 515 | 539 | 583 | 609 |
| Account 2 | 238 | 285 | 337 | 413 | 466 |
| Recoverable claims after provisioning | **292** | **368** | **429** | **531** | **605** |
| Account 1 | 190 | 223 | 234 | 264 | 284 |
| Account 2 | 102 | 145 | 195 | 267 | 321 |
| Interest on unrecovered claims after provisioning | **116** | **134** | **134** | **143** | **146** |
| Account 1 | 115 | 133 | 133 | 142 | 145 |
| Account 2 | 1 | 1 | 1 | 1 | 1 |
| Underwriting funds – net of reinsurance | **629** | **582** | **547** | **553** | **542** |
| Account 2 | 629 | 582 | 547 | 553 | 542 |
| Recoverable capital loans before provisioning | **505** | **381** | **119** | **82** | **104** |
| Account 4 | 15 | 32 | 51 | 75 | 104 |
| Account 5 | 490 | 349 | 68 | 7 | - |

## Account 1

The main activity relating to this account is the administration and collection of the claims paid out against these guarantees and insurance policies. In accordance with standard accounting practice, UKEF provides prudently against the possible non-recovery of debts. Where the outlook for recovery improves, the level of provision is reduced accordingly, releasing profit to the Statement of Comprehensive Net Income. The key results (rounded to the nearest million) were as follows:

- Net operating income was £9 million compared with £63 million in 2016-17. The decrease in net operating income was due to a foreign exchange loss of £20 million in 2017-18 compared with a gain of £25 million in 2016-17.
- Recoveries of claims paid were £34 million compared with £47 million in 2016-17.
- Recoveries of interest on claims paid were £26 million compared with £28 million in 2016-17.
- The balances for gross claims decreased from £515 million in 2016-17 to £463 million during the year, while those for net claims decreased from £223 million in 2016-17 to £190 million during the same period.
- Interest on net unrecovered claims decreased from £133 million in 2016-17 to £115 million during the year.
- There is no non-claims exposure on this account.

## Account 2

The key results were as follows:

- The total of guarantees and insurance policies (net of reinsurance) that were issued and effective during the year was £1,865 million compared with £2,178 million at 31 March 2017.
- Net premium income was £103 million compared with £102 million in 2016-17.
- Net operating income was £22 million compared with £70 million in 2016-17. The decrease in net operating income was mainly due to a foreign exchange loss of £7 million in 2017-18 compared with a gain of £23 million in 2016-17.
- Claims authorised and paid or payable during the year decreased to £2 million from £8 million in 2016-17.
- Claim recoveries for the year were £42 million compared with £73 million in 2016-17.
- Gross claims balances were £238 million compared with £285 million in 2016-17.
- Net claims balances were £102 million compared with £145 million in 2016-17.

## Account 3

No new guarantees were issued on this account during the year. All exposure on this account has run off.

## Account 4

The results were as follows:

- The direct funding balance represents the funds originally loaned by HM Treasury to reduce the cost of FREF. The balance continued to reduce during the year to £15 million from £32 million in 2016-17, as regular instalments were made.
- Net operating income was £2 million in 2017-18 compared with £4 million in 2016-17.

## Account 5

- This account relates to direct lending activity. During the year 7 new loans were originated (2 loans were originated in 2016-17). There are now 14 loans drawing or drawn.
- There was a net operating loss of £28 million in 2017-18 compared with net operating income of £12 million in 2016-17. This decrease was largely as a result of a foreign exchange loss of £38 million as most of the loans originated were in US Dollars.

## Explanation of variances between Estimate and outturn summary

Parliament sets a limit on the annual amount of resource and capital that UKEF can consume through the Supply Estimates process. The table below compares UKEF's Estimate with actual outturn. Further information on the Supply Estimate is available on UKEF's website.

In the absence of any operating income outside the ambit of the Estimate, UKEF's net resource outturn and net operating cost or income are identical.

UKEF supports export credit loans denominated in foreign currency and as a result is exposed to foreign currency exchange risk arising from fluctuations in exchange rates of various currencies. Almost all of UKEF's premium income arises in currencies other than sterling (mostly US dollars) and net assets are denominated in a variety of currencies, of which the largest is US dollars. As UKEF is not authorised by HMT to hedge exchange rate exposures, it faces challenges to ensure compliance with Parliamentary voted control totals.

From January each year, which is the last opportunity to adjust voted control totals, to 31 March, there is a risk that exchange rates move and reduce net income by more than the headroom agreed with HMT and voted by Parliament.

| | SoPS Note | 2017-18 Estimate £'000 | 2017-18 Outturn £'000 | 2017-18 Variance £'000 |
|---|---|---|---|---|
| Budget spending: | | | | |
| Departmental expenditure limit (DEL) | SoPS1(a) | (499) | (499) | - |
| Annually managed expenditure (AME) | SoPS1(a) | 148,402 | (4,619) | 153,021 |
| **Resource total & net operating cost/(income)** | | **147,903** | **(5,118)** | **153,021** |
| Non-budget/resource total | SoPS1(a) | - | - | - |
| **Net resource outturn & net operating cost/(income)** | | **147,903** | **(5,118)** | **153,021** |
| Budget spending: | | | | |
| Departmental expenditure limit (DEL) | SoPS1(b) | 800 | 671 | 129 |
| Annually managed expenditure (AME) | SoPS1(b) | 524,959 | 167,736 | 357,223 |
| **Capital total payments/(receipts)** | | **525,759** | **168,407** | **357,352** |

### Significant highlights:

All UKEF income and expenditure is classified as either DEL or AME and there is no non-budget.

### Resource – Note SoPS1(a):

AME £153 million – This variance is largely due to provision and foreign exchange movements (in particular in relation to a strengthening of sterling against the US dollar of some 12% during the year) which cannot be forecast with certainty and are unhedged. A more detailed explanation of UKEF's foreign exchange risk can be found in the credit risk, portfolio overview and pricing report on page 41 and Note 20 of the financial statements.

### Capital – Note SoPS1(b):

AME £357 million – This variance is largely due to the direct lending facility. Most business is written in currencies other than Sterling (primarily US Dollars) therefore it is subject to foreign exchange volatility. The variance is largely due to the fact that whilst it is necessary to ensure there are sufficient voted funds, and therefore headroom to meet potential demand in year, it is not possible to predict actual demand (and therefore the associated drawings). Many deals may not close for reasons beyond the control of the department or the timing of loan origination changes. More details of UKEF's risks, including foreign currency and liquidity risk, can be found in the Credit Risk, Portfolio Overview and Pricing Report.


UKEF supported the sale of Bombardier C Series aircraft for the first time, to Korean Airlines

# Head of Environmental and Social Risk's report

**UKEF examines the environmental, social and human rights (ESHR) risks and potential impacts of projects we are asked to support and monitors their ESHR performance in line with our published ESHR policy. In addition, we collaborate with other export credit agencies and financial institutions regarding ESHR matters, with the aim of establishing a 'level playing field' in respect of ESHR risk management across these institutions.**

**Max Griffin**
Head of Environmental and Social Risk Management

In 2017-18, UKEF was appointed to the Steering Committee of the Equator Principles, a voluntary environmental and social risk management framework followed by many international financial institutions, having adopted them on 31 March 2016.

> **"As a member of the Equator Principles Steering Committee, UKEF will play its role in promoting sustainable business practices among the global trade community. Its appointment is a recognition of the UK government's commitment to sustainable financial decision-making."**
> - **Rt Hon. Greg Hands MP**, Minister of State for International Trade (June 2018)

During 2017-18, all transactions that fell within the scope of the OECD Recommendation of the Council on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence[15] (the 'OECD Common Approaches') and/or the Equator Principles[16] were screened for ESHR risks. These two frameworks are complementary but in some cases apply different criteria to determine whether a project falls in scope. Where we identified significant risks, these transactions were categorised as either A (high risk) or B (medium risk) and we carried out an ESHR due diligence review.

In undertaking ESHR reviews, we place emphasis on early dialogue with exporters and other relevant parties to the transactions. The aim is to ensure that projects to which UK exports are destined align with the relevant international ESHR standards prior to our support being provided and subsequently throughout the period of support. Where applicable, UKEF seeks to support project sponsors in designing and implementing management systems that represent good international industry practice, mitigating negative impacts and enabling positive impacts to be achieved where possible. UKEF's benchmark ESHR standards are typically the International Finance Corporation's (IFC) Performance Standards on Environmental and Social Sustainability.

Our ESHR due diligence and monitoring is carried out by UKEF's professionally qualified and experienced Environmental and Social Risk Management (ESRM) team. Where appropriate this is supported by external ESHR consultants.

**15** https://www.gov.uk/government/publications/uk-export-finance-environmental-social-and-human-rights-policy/policy-and-practice-on-environmental-social-and-human-rights-due-diligence-and-monitoring
**16** http://equator-principles.com/

## ESHR due diligence

In 2017-18, we worked with a wide variety of project developers and exporters to help them understand and manage ESHR risks associated with their project activities. We supported[17] 2 category B transactions that fell within the scope of both the OECD Common Approaches and the Equator Principles. A further 1 Category A and 6 Category B transactions were supported, which fell within the scope of the OECD Common Approaches only.

In addition, a total of 2 transactions were supported which were within the scope of the OECD Common Approaches as ‘Existing Operations’[18] and had ESHR risks that warranted review.

No transactions falling only within scope of the Equator Principles were supported by UKEF this year.

UKEF had a positive impact on projects through ESHR risk management, for example:

- **Airport development, Uganda** (Category A)
  UKEF was asked to support the construction of Kabaale Airport, Uganda’s second international airport. This greenfield development featured a UK exporter and project developer which were both new to UKEF. The review included a visit to Uganda to meet the relevant Ugandan authorities and project developer alongside the exporter, UK embassy and Department for International Development staff. UKEF’s involvement in the project led to the development of supplementary environmental and social impact assessment studies (and, subsequently, management plans) including detailed assessments of the potential impact on water resources and biodiversity, as well as cumulative impacts. Additional stakeholder engagement plans were developed and UKEF obtained a commitment from the Uganda Civil Aviation Authority that it would undertake modelling of emissions to air and noise. UKEF agreed to provide support after the authority committed to completing an agreed environmental and social action plan.

- **Infrastructure project, UAE** (Category B)
  The ESRM team engaged with technical and environmental managers to explain and agree an updated ESHR management approach appropriate to the Dubai Arena project, having worked with the project sponsor previously. This was designed to further improve monitoring of the environmental and social performance throughout the duration of UKEF support.

Details of the ESHR risk and impact categorisation of all civil (non-aerospace) cases for which support was issued during 2017-18 and that fall within the scope of the OECD Common Approaches and/or Equator Principles are available on UKEF’s website.

## ESHR monitoring

UKEF conducts ESHR monitoring of all category A and B projects where support has been issued. This allows us to track the implementation of ESHR commitments and to be satisfied that the projects continue to align with the relevant international standards for the duration of our support, both during project construction and operations. Our monitoring includes reviewing self-monitoring reports produced by project developers, commissioning independent environmental and social consultants (IESC) to monitor projects on our behalf, and/or UKEF carrying out site visits. The level and frequency of our monitoring varies relative to the ESHR risks involved.

**17** ‘Supported’ refers to transactions where finance documents were signed and became effective (for example first drawdown took place and UKEF is on cover) within the March 2017 – April 2018 period.

**18** ‘Existing Operations’ are determined within the OECD Common Approaches as referring to applications relating to exports of capital goods and/or services to an identified location where there is an existing undertaking that is undergoing no material change in output or function.

UKEF seeks to influence positively the application of standards throughout the monitoring process in order to improve ESHR outcomes. This may include influencing the project developer:

- to promote positive health and safety behaviours, minimising accidents, injury and loss of life
- in re-establishing the livelihoods of people affected by the project
- in the provision of appropriate worker conditions and accommodation
- in promoting positive project impacts
- to ensure that all relevant environmental conditions are met through the project life cycle

The following are examples of our ongoing monitoring commitments for 2017–18 across both Category A and Category B projects:

- **Liwa Plastics Project, Oman** (Category A)
Construction of the plant and 300km natural gas liquids pipeline commenced in 2017. The pipeline construction crew operates in very remote locations. UKEF's interactions as part of the ECA group with the project developer and main contractor have focused on heat stress management, health and safety management, more rapid provision of a mobile ambulance and the undertaking of timed drills for emergency response along the route.

- **Rural Bridges Phase II, Sri Lanka** (Category B)
UKEF's ESRM team collaborated with the exporter, Cleveland Bridge UK Limited, and supported it in developing a rapid ESHR assessment methodology and report to be undertaken for each of the 500+ proposed bridge sites for review by the ESRM team before construction could take place. ESHR reports for bridge sites received by the ESRM team during 2017 noted that some bridges were to be located within or in close proximity to national parks. Given the heightened potential biodiversity impacts of bridge construction in these areas, the ESRM team encouraged the exporter to develop enhanced procedures with the relevant Sri Lankan authorities to help mitigate impacts to biodiversity over and above the existing management plans. These plans will ensure biodiversity management procedures meet internationals standards when sites are within or near national parks and other high-risk areas.

A summary of cases that fall within the scope of the OCED Common Approaches and/or Equator Principles where we are undertaking ongoing ESHR post-issue monitoring can be found on our website.

## International ESHR co-operation

In support of UKEF's objective to achieve fairer competition by seeking to establish a 'level playing field' for all OECD exporters, we work alongside other ECAs at the Environmental and Social Practitioners' Group of the OECD Export Credit Group (ECG). We are actively involved in setting the agenda, sharing experiences, participating in working groups and seeking to achieve consistency in ECAs' approach to ESHR risk management practices under the OECD Common Approaches.

In June 2017, UKEF was elected by the Equator Principles Financial Institutions (EPFI) to join the Equator Principles' Steering Committee in a management support role. We were actively involved in the Equator Principles Annual Meeting, sharing experience and engaging and collaborating with EPFI colleagues. A significant outcome of the meeting was the agreement to update the Equator Principles by mid-2019 and UKEF will continue to proactively participate in this process.

UKEF participates in ESHR practitioner meetings of several multilateral financial institutions. This includes the IFC Community of Learning, as well as meetings of other development and commercial banks and ECAs. UKEF also attended a number of international ESHR industry conferences this year, including the annual conference of the International Association of Impact Assessment and the Institution of Environmental Management and Assessment's launch event for a new Global Environmental Assessment group.

A bridge constructed by Cleveland Bridge in Sri Lanka with UKEF support

# Export Guarantees Advisory Council report

**The Export Guarantees Advisory Council's role is to advise the Secretary of State for International Trade and the Minister for Trade and Export Promotion on the policies that UKEF applies when doing business, particularly those related to UKEF's application of ethical policies.**

**Andrew Wiseman**
Chair, Export Guarantees Advisory Council

These policies are established by international agreements that relate to export credit agencies (ECAs) and relate to potential environmental, social and human rights risks of the projects UKEF supports, debt sustainability and anti-bribery and corruption procedures. The Council also considers transparency issues including freedom of information.

Members of the Council are appointed by the Minister responsible for UKEF. Members are not remunerated, but provide their services on a voluntary basis.

In 2018, the Council welcomed two new members.

John Morrison is the founding Executive Director of The Institute for Human Rights and Business. He holds over two decades of business and human rights advisory experience.

Dr Roseline Wanjiru is a Senior Lecturer at Newcastle Business School. She brings over twenty years' experience with interdisciplinary research interests in economic development, trade and industrial policy, foreign direct investment and innovation strategies.

The Council's current members are:

### Chair

- **Andrew Wiseman**, Partner, Harrison Grant Solicitors

### Members

- **Gillian Arthur**, previously Head of Philanthropy Services, Sanne Group
- **Alistair Clark**, Corporate Director, Environment and Sustainability Department, European Bank for Reconstruction and Development
- **Alexandra Elson**, Senior Stakeholder Relations Adviser, Shell plc
- **Neil Holt**, Corporate anti-bribery adviser
- **John Morrison**, Executive Director of the Institute for Human Rights and Business
- **John Newgas**, over 20 years' experience in the manufacturing industry
- **Anna Soulsby**, Associate Professor of Organisational Behaviour, Nottingham University Business School
- **Dr Roseline Wanjiru**, Senior Lecturer and Programme Leader at Newcastle Business School

During 2017-18, the Council met with the newly-appointed Minister of State for Trade and Export Promotion, Baroness Fairhead, and communicated with the Secretary of State for International Trade, Dr Liam Fox MP, on specific issues.

In addition, the Council meets with UKEF representatives to provide advice and carry out reviews to understand how UKEF's principles and policies are applied in practice.

The Council met on 4 occasions this year. Senior officials from UKEF, including the Chief Executive, attended each of these meetings, and briefed the Council on issues and developments over the year, and on individual export transactions supported by UKEF.

## Anti-bribery and corruption

In 2017-18, Organisation for Economic Co-operation and Development (OECD) member countries undertook a review of the OECD Recommendation on Bribery and Officially Supported Export Credits (OECD Bribery Recommendation). The Council provided advice to UKEF in advance of the multilateral negotiations, supporting UKEF's approach to strengthening the recommendation to raise standards for all OECD members.

The Council was regularly updated on these international negotiations and sent a letter to the Secretary of State for International Trade to brief him on developments.

Each year, as an assurance exercise, the Council reviews the application by UKEF of the OECD Bribery Recommendation, and in December it considered the annual report from UKEF on its application of the Recommendation. The annual report provides a detailed overview of UKEF's anti-bribery due diligence through the year.

## Environmental and social risk management

The Council is responsible for scrutinising and advising UKEF on its environmental, social and human rights (ESHR) risk management. The Environmental and Social Risk Management team (ESRM team) is responsible for implementing UKEF's ESHR policy, which includes identifying, reviewing and, where support is provided, monitoring ESHR risks and impacts in accordance with the OECD Recommendation on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence (OECD Common Approaches) and the Equator Principles.

In 2017, UKEF staff gave a presentation on health and safety management to the Council. This set out the context in which health and safety issues are considered during both due diligence and post-issue monitoring. The presentation summarised the issues most frequently observed, supported by case study examples.

In 2017 the Council focused on gender issues in connection with projects supported by UKEF and requested that the ESRM team review its activities from a gender perspective. The Council reviewed UKEF's initial findings from research into how gender is considered by other ECAs and international financial institutions. The ESRM subsequently updated the Council on enhancements to its screening process and team guidance to better identify gender related risks and opportunities. The Council welcomed UKEF's approach and recommended that UKEF take a leadership role in this area among ECAs and project sponsors, emphasising the positive benefits of gender equality and raising gender issues with project sponsors and exporters at early stages of projects.

The ESRM team presented its annual report to the Council on the activities carried out by the team during 2017. The report highlighted a number of projects where UKEF had been able to positively influence through its ESHR due diligence and monitoring the management of ESHR risks. The Council recognised the increased workload, and particularly noted the quality of the ESRM team's work. The Council was pleased to see that ESHR risk management was a core UKEF activity, fully embedded into UKEF's due diligence processes and that UKEF was leading and influencing other ECAs in the ESHR field, becoming a centre of excellence within government.

## Advice on individual cases

The Council does not provide advice on decisions UKEF makes to support individual export transactions and projects. However, it does carry out reviews to understand how UKEF's principles and policies are applied in practice. As appropriate, it also gives advice on how these might be further developed.

One way the Council does this is by asking UKEF to report on projects.

During 2017-18, UKEF representatives discussed with the Council the processes applied to projects that have been classified, based on the project ESHR risks, as Category A (high ESHR risk) or B (medium ESHR risk). The Council reviewed how UKEF undertook its ESHR due diligence and monitored projects' management of construction and operation phase ESHR risks after UKEF support has been provided. The Council paid particular attention to the application of the OECD Common Approaches and the Equator Principles.

For example, in 2017, the Council reviewed the ESHR due diligence and monitoring activities relating to a project supported by UKEF in Ghana. The Offshore Cape Three Points project involves the development of offshore oil and gas fields off Ghana's coast and an on-shore gas receiving facility. The project is intended to fuel up to 1,000 megawatts of power generation, helping Ghana meet its growing energy needs and displace oil-fired power generation with a cleaner fuel alternative. The Council noted the work of the ESRM team in building relationships with the project developers and operators to ensure appropriate environmental and social monitoring and notification requirements were in place during both construction and operations phases.

In addition to reviewing individual cases presented by the ESRM team, the Council has also provided advice to UKEF on other cases in order to assess the principles and policies relating to bribery and corruption.

During 2017-18, the Council reviewed UKEF's engagement with companies under investigation by the Serious Fraud Office (SFO). In addition, the Council also paid particular attention to the need to develop a response to new legal mechanisms as they are developed, for example deferred prosecution agreements with the SFO.

The Council noted the actions taken by UKEF to extend due diligence and monitoring of these companies. The Council noted that the processes that UKEF has put in place are key to promoting transparency and compliance.

## Other work of the Council

Throughout the course of the year, the Council reviewed UKEF's handling of information requests made under the Freedom of Information (FoI) Act and the Environmental Information Regulations. The Council recognised the very high proportion of requests answered within statutory deadlines, with a response rate of 94% within deadline for FoI requests in 2017.

The costs of operating the Council during 2017-18 amounted to circa £3,000, largely to reimburse the cost of travel and meeting expenses.

The Council's Terms of Reference, Register of Members Interests, minutes of its meetings and contact details can be found on the government's website: www.gov.uk/government/organisations/export-guarantees-advisory-council.

For further information on the work of the Council please contact the Council Secretary: chiefexecutiveoffice@ukexportfinance.gov.uk.