Appendix E: State of Play in the OECD

Introduction

One of Ex-Im Bank's primary objectives is to level the playing field for U.S. exporters facing foreign competition supported by their governments' official export finance programs. However, particularly in the late 1970's and early 1980's, the financial cost of leveling the playing field could be huge. The most successful long-term tool for both leveling the playing field across the board and minimizing the cost in those cases Ex-Im does match has been the multilateral negotiations at the OECD. Since the Arrangement came into force over twenty-five years ago, OECD ECAs have agreed to critical disciplines on repayment terms, interest rates, tied aid and exposure fees, in addition to rules on specific sectors such as large commercial aircraft. These disciplines have significantly reduced the potential volume of subsidized transactions that Ex-Im Bank would need to match, thereby saving the U.S. government hundreds of millions of dollars annually. Of critical importance, these official export finance disciplines have created room for the private export finance sector to operate.

With disciplines on most financial aspects of standard export credits and tied aid agreed, the OECD Working Party on Export Credits and Credit Guarantees in aggregate has experienced positive cash flows since the mid-1990s. This development, while obviously positive, has nonetheless removed the major impetus ECAs had to reach multilateral agreements on additional financial disciplines. For the past several years, the member countries have focused instead on a variety of issues along a much broader spectrum of non-financial concerns. Such work continued in 2003.

Typical Official Export Credit Negotiations Process:

The process of adopting multilateral rules to eliminate official export credit subsidies and level the playing field typically involves the following five stages:

1. Agreement to exchange information or establish transparency in order to provide the basis for work on a particular issue;

2. Creation of a system or framework of rules that can lead to reductions in subsidy and/or further level the playing field;

3. Establishment of a yardstick within the framework by which progress can be measured (e.g., charging market level interest rates or requiring a project to be commercially non-viable in order to allow tied aid);

4. Moving the yardstick higher (i.e., requiring ever higher interest rates until zero subsidy is achieved, or increasing the minimum concessionality in tied aid); and

5. The ongoing process of refining and adapting any rules as more knowledge becomes available and/or the world changes.

Against this framework, 2003 witnessed developments in the following areas:

- A revision of the Arrangement
- Adoption of the Common Approaches for the Environment
- Proposals on untied aid disciplines and transparency

The sections below provide a more detailed summary of these issues.

The Arrangement

The Arrangement on Officially Supported Export Credits, or the Arrangement, first came into effect in 1978 when OECD governments agreed the initial rules to constrain the provision of subsidies in support of their national exporters. By limiting subsidy competition amongst governments, the Arrangement leveled the playing field for exporters and shifted competition from the terms of financing to the quality of the goods and services being exported. The disciplines of the Arrangement have evolved and expanded over time to place significant parameters around the provision of official export credits. According to the framework above, many aspects of the Arrangement have been in stage 5 for a number of years.

Historically, there has been two means of ensuring compliance with export credit rules: the moral suasion embodied in the Arrangement and formal WTO processes. As a "Gentlemen's Agreement" rather than a formal treaty or convention, the Arrangement has traditionally been enforced by transparency (notifications and exporter competition), peer pressure (consultations) and the knowledge that violating the rules of the Arrangement would be met immediately by high-level political response and/or similar action from other governments (matching). Since 1979, the Arrangement's interest rate provisions have been codified in the WTO's Agreement on Subsidies and Countervailing Measures (ASCM) as a "safe haven" under which official export credits may be provided without being considered a prohibited export subsidy. WTO rules are enforced by formal suits brought by parties claiming injury, and remedies can include discontinuation of the program in violation of WTO rules and financial penalties.

The tension between these types of agreements – "Gentlemen's Agreement" versus international law – and the related enforcement mechanisms – notifications, consultations, moral suasion and matching versus suits and legally binding penalties – was highlighted in the long-running Canada-Brazil aircraft disputes in the WTO. In particular, the "safe haven", item k(2) of Annex I of the ASCM, refers only to the "interest rate provisions" of the Arrangement. WTO Dispute Settlement Panels found that matching non-conforming transactions is not in conformity with the ASCM; in other words, being in conformity with the Arrangement *as a whole* (e.g., following the rules for matching) does not equate to being in conformity with the ASCM. In addition, in the WTO's Doha Development Agenda discussions, Brazil and India argued that it is unfair that the Arrangement rules are negotiated by OECD countries only but apply to all countries due to its inclusion in the ASCM.

As a result of these concerns, the Participants to the Arrangement revised the Arrangement from late 2002 through 2003, and a new Arrangement came into effect as of January 1, 2004. The goals of the redrafting of the Arrangement were: (1) to improve the consistency of the text

with regard to the ASCM; (2) to provide more transparency for non-Participants; and (3) to enhance the clarity and user-friendliness of the Arrangement for non-Participants.

Transparency for non-Participants was enhanced by enabling non-Participants to have more information about how the Arrangement functions. First, non-Participants will now have access to Participants' standard export credit notifications. Second, Participants and non-Participants are expected to respond "on a reciprocal basis" to each other's case-specific inquiries in competitive situations. In addition, the Arrangement was reorganized to reduce redundancies and more clearly present the rules. Finally, all information on the calculation of exposure fees has been moved from technical ancillary documents into the body of the Arrangement.

The one area of substantive change made during the redrafting of the Arrangement was the elimination of the derogation related provisions. This was done to bring the Arrangement into conformity with the WTO rulings in the Canada-Brazil dispute mentioned above. The retention of provisions for matching derogations was considered inconsistent with the ASCM because it implied that Participants could either derogate or match derogations and, through notification, be in conformity with the ASCM (which incorporates the Arrangement through item k). As the WTO panels had found to the contrary, the Participants decided that all references to derogations needed to be removed from the Arrangement.

Environment

In December 2003, after years of work, the OECD finally concluded an agreement on ECAs' environmental review of sensitive projects, called the OECD Recommendation on Common Approaches on Environment and Officially Supported Export Credits, or "the Common Approaches." This agreement represents a significant step forward in leveling the playing field for major projects and in ensuring that export credit support for these projects does not contribute to environmental degradation.

The major achievements of the 2003 Common Approaches are provisions that require the use of international standards for environmental review and that expect disclosure of environmental information prior to approval of sensitive projects. Inadequate treatment of both these issues caused the United States to refuse an earlier draft text in 2001, leading the other OECD ECAs to unilaterally and voluntarily implement their own environmental review procedures based on that draft text. By agreeing to the 2003 text, ECAs agreed to apply the higher of host country or international standards when reviewing projects; the acceptable standards are limited to those of the major multilateral development banks, and most ECAs in most projects are likely to use World Bank standards and guidelines. In addition, ECAs agreed to require environmental impact assessments (EIA) for the most sensitive cases and are expected to make EIAs or other environmental information publicly available at least 30 days prior to final commitment. Only under rare circumstances may ECAs not adhere to these provisions, and they will report these cases to the OECD. Finally, the Common Approaches includes reporting measures that will enable ECAs to monitor each other's progress in applying the agreement.

The 2003 Common Approaches is a significant achievement for OECD ECAs. More importantly, it has leveled the playing field for U.S. exporters, who have since 1994 been subject to Ex-Im

Bank's environmental standards and transparency procedures. Thus, the OECD's environmental disciplines advanced to stage 3 in 2003.

Tied and Untied Aid

Disciplines on tied aid have been in place since 1992 and have gradually been fine-tuned over time. 2003 saw the Ex-Ante Guidance on Tied Aid updated to include energy pipelines as a sector normally ineligible for tied aid, and a precedent was set for freight transportation to normally be considered ineligible for tied aid. (The latter should be added to the Ex Ante Guidance during the next revision.) In addition, the separate tied aid bans for Eastern Europe, and select countries of the former Soviet Union, were merged, updated and incorporated into the Arrangement. Thus, the tied aid negotiations remain at the early phase of stage 4.

Continuing its efforts to achieve disciplines for untied aid, the United States advanced a proposal for increased untied aid disciplines and transparency, including disclosure of bid winners. There are currently no Arrangement rules governing untied aid, because the donor government does not legally tie procurement to its firms. However, untied aid can be "de facto tied" and used to circumvent the tied aid disciplines that require a minimum concessionality and preclude tied aid for commercially viable projects and to rich countries. While untied aid is notified and is the subject of an OECD report, notifications are not currently releasable to potential bidders, and allowing their release would facilitate wider bidding participation. The disclosure of bid winners would go a long way toward ensuring over the long-term that untied aid is effectively untied. Due to Japanese and German resistance to transparency and disciplines, untied aid discussions did not move beyond stage 1 in 2003.

Exposure Fees (Risk Premia)

ECAs charge exposure fees for taking the risk that the obligor will not repay. Rules seeking convergence on exposure fees for officially supported export credits of over two years came into force on April 1, 1999. The agreement, called the Knaepen Package, sets minimum exposure fees for sovereign transactions, and the sovereign benchmark sets the minimum rate for all other transactions within the country. Except for aircraft and ships, which are subject to separate disciplines, all transactions subject to the Arrangement must comply with the exposure fee disciplines.

The fee negotiations have remained at stage 3 since the inception of the Knaepen Package. In 2003, Participants continued an ongoing transparency exercise on buyer risk pricing and finalized one feedback system for a long-term evaluation of fees. Given the wide disparity between ECAs' private buyer pricing, pressure remains to open negotiations on developing a formal buyer risk pricing agreement. The United States will continue to advocate that buyer risk assessment be market-based, rather than based solely on buyer type, as in the structural pricing system imposed by many European ECAs (that is, these ECAs add a fixed increment based on the type of obligor, rather than assessing the ability of the obligor to repay the debt and pricing according to that risk).

Interest Rates

There was very little discussion of official export credit interest rates in 2003. Fixed interest rate provisions for ECA direct loans, or Commercial Interest Reference Rates (CIRR), have long been subject to rules that have largely neutralized competition and eliminated subsidy. Two long-standing issues with competitiveness implications remain unresolved: (1) the different ways in which ECAs interpret the rules on setting and holding CIRR rates, and (2) interest make-up (IMU) schemes, a tool largely used by European ECAs in conjunction with their commercial banks and that may involve a degree of subsidization. The ongoing lack of formal action is due to the linkage of these issues to other issues, such as market windows and exposure fees, although in 2004 Participants may discuss CIRR setting and holding. In sum, the interest rate negotiations on the current fixed rate CIRR regime as a whole have advanced to stage 5 and represent the issue for which the most progress has been achieved to date.

This issue of creating a floating rate CIRR arose in 2000 as a result of the WTO dispute between Canada and Brazil over export credit support for regional aircraft. In these cases, the WTO found that, under the ASCM, officially supported export credits are a prohibited subsidy unless they are on market terms (from the borrower's perspective, i.e., the benefit to the borrower test) or the support is in compliance with the OECD Arrangement interest rate provisions. The WTO held that the OECD interest rate provisions only yield a safe harbor for the CIRR fixed interest rate and, therefore, provide no safe harbor for individually determined floating rate lending by ECAs or for pure cover transactions (guarantees and insurance). Due to the technical and political complexity of designing a floating rate CIRR that does not compete with commercial bank activity, and the resulting U.S. and European opposition to such an instrument, work on a floating rate CIRR has not progressed beyond stage 1.

Large Commercial Aircraft

Since the 1980s, the Large Aircraft Sector Understanding (LASU) of the Arrangement has governed the provision of official export credit support for large commercial aircraft (airplanes that have more than 70 seats and are powered by a jet engine). The LASU was created to fit the unique characteristics of the large aircraft financing business, providing longer repayment terms and special interest rate structures, although it does not have exposure fee rules.

The primary LASU participants are the European ECAs that support Airbus (France, Germany and the United Kingdom) and the United States. Ex-Im Bank meets regularly with its foreign counterparts to discuss issues of common interest, but to date there has been no consensus between the European ECAs and Ex-Im Bank regarding modifications to the LASU.

The entry of Canada and Brazil into the large aircraft sector, however, could very well provide the impetus to reopen LASU discussions. In April 2003, LASU participants held exploratory discussions with Canada and Brazil about their respective aircraft finance systems. While the discussions did not progress further in 2003, Brazil has been invited to another OECD meeting in 2004, which may open the door to further talks between the main aircraft manufacturing countries. Thus, while this issue remains in stage 4, it could move to stage 5 during 2004.

Market Windows

A market window is an institution (or a part of an institution) that claims to operate on a commercial basis while benefiting either directly or indirectly from some level of government support. Market windows pose competitive challenges and transaction-specific problems to other ECAs because:

- The support provided by such entities is only available to their national economic interests; and

- The attractiveness of the financing packages (especially interest rates) provided by market windows tends to stretch the boundaries of what a private institution might be willing to provide.

The United States believes that market window activity represents a potential threat to the disciplines that the OECD Arrangement negotiations have sought to instill in all official lenders. Nonetheless, due to ongoing resistance from the Participants with major market windows (Germany with KfW, Canada with EDC) to agree even to share information about their activity, let alone agree to disciplines, little progress has been made at the OECD. Thus, the market windows issue has not even reached stage 1. To progress the issue, Ex-Im Bank is working with both EDC and KfW on a bilateral basis to increase the amount of information available to the Bank on transaction terms.