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Selection and Development of

A PRIVATE SECTOR FINANCING INSTRUMENT

prepared for

THE UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT

under Contract No. AID-otr-C-1499 W.O. No. 17

SEPTEMBER 1979

prepared by

PEAT, MARWICK, MITCHELL & CO.

with

BROWNSTEIN ZEIDMAN AND SCHOMER

PEAT, MARWICK, MITCHELL & CO.
1990 K STREET, N. W.
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September 11, 1979

Mr. Carl H. Leonard
Office of Development Resources
Bureau for Latin America and the
Caribbean
United States Agency for International
Development
New State Department Building
320 21st Street, N.W.
Washington, D.C. 20523

Dear Mr. Leonard:

Peat, Marwick, Mitchell & Co. is pleased to submit its final report, Selection and Development of a Private Sector Financing Instrument. This report represents our findings and conclusions concerning the design of a financing instrument that would allow AID to attract private sources of capital for investment in a range of projects within the Latin American and Caribbean countries.

This report incorporates the results of interviews with a number of commercial banks and major life insurance companies in this country, and presents comments, suggestions, and recommendations that were offered about the design of a financing instrument. The report essentially describes the extent of interest and the cautions expressed by the domestic financial community. As a result, we feel that it is a representative assessment of the marketability of each of the alternatives considered.

During the course of this study, the PMM&Co. project team benefited from the cooperation and enthusiasm demonstrated by the AID staff, members of the international finance community in Washington, and officials representing a broad range of financial institutions throughout the country. We are particularly grateful for the work and counsel provided by the staff of Brownstein Zeidman and Schomer, who were subcontractors to us in the course of this study.

Very truly yours,

PEAT, MARWICK, MITCHELL & CO.

Peat, Marwick Mitchell

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PREFACE

This report presents Peat, Marwick, Mitchell & Co.'s (PMM&Co.'s) evaluation of alternative financing instruments that the Agency for International Development (AID) could use to facilitate private sector financing of its projects, beginning with those in middle-income Latin American and Caribbean (LAC) countries. The report describes our selection of promising financing instruments for further development and identifies features of the selected instruments that would enhance their viability in U.S. financial markets. We have also suggested ways in which a new AID program of private sector financing could be implemented.

EXECUTIVE SUMMARY

BACKGROUND

The need for this study has arisen from an increasing concern that the United States is losing its means of assisting in the development of Latin American and Caribbean (LAC) countries. As the LAC countries have increased their levels of economic activity, they have moved out of the category of low-income countries qualifying for most of the U.S. Government's international assistance programs. At the same time, alternative forms of U.S. Government assistance to such "transitional" countries have been limited. Last year, in a report on the International Development and Food Assistance Act, the House Committee on Foreign Affairs expressed concern over the reduction of U.S. development assistance to countries classified as middle income. The Committee directed AID to review its development objectives toward middle income countries, particularly in Latin America, as well as the level of resources which the U.S. should devote to their development. The Committee also requested AID to "investigate what on-going or potential mechanisms can be utilized to assist the development efforts."

In response, AID's Bureau for Latin America and the Caribbean has undertaken an examination of new approaches to development financing which could contribute to the growth of the LAC region. In testifying before the Subcommittee on Inter-American Affairs of the House Committee on Foreign Affairs, AID's Assistant Administrator, Abelardo L. Valdez, described the efforts which were underway:

> ...In a period of budget austerity, we recognize clearly the value of new development instruments that do not wholly depend on U.S. Government funding. We are therefore studying the feasibility of a development investment guarantee mechanism--similar to A.I.D.'s successful Housing Investment Guarantee Program--and other creative ways of directing more technical and financial resources to the Region's most critical development problems.

The purpose of this study is to explore specific financial instruments that might facilitate participation in the LAC development process by private sector investors and lenders in the United States.

INSTRUMENTS SELECTED

Two financing instruments appear to have the necessary characteristics to be marketable and to satisfy AID's program needs. One is an instrument that is fully guaranteed by the U.S. Government, and one bears no U.S. Government guarantee. Both would be structured as a loan made by a private lender in the United States to a developing country receiving assistance from AID. Both would be matched with an AID loan to the same borrower to form a program of co-financing.

The Fully Guaranteed Loan

A private sector loan fully guaranteed by the U.S. Government would most completely fulfill the objectives established by AID's Latin America Bureau. Specifically, it would:

- generate broad market interest;
- provide financing for a full range of AID projects and middle-income borrowing countries;
- utilize AID's capability and experience in project planning, analysis, and implementation monitoring;
- be used on a recurring basis with relative ease, starting with the LAC countries;
- provide, in combination with AID resources, generous terms and conditions to AID borrowers; and
- attract a substantial amount of private sector funds to match AID resources.

However, AID is not currently authorized to employ such an instrument. New legislation would be required to provide additional guarantee authority. Consequently, an alternative instrument approach which relies upon no guarantee should also be considered.

The Unguaranteed Loan

A program of co-financing in which the private sector loan is unguaranteed has the advantage of near-term feasibility. It can be implemented under AID's current authority. However, it fulfills AID's objectives less well than does the fully guaranteed loan. It appeals to a narrower market. It is likely to provide private sector funds only to the more creditworthy of AID's borrowers and the more financially viable of AID's projects. The extent to which it will utilize AID's experience in project development and the extent to which it can be used on a recurring basis are subject to negotiation with private lenders. We believe that, through selective application, an unguaranteed instrument can, in combination with AID resources, provide attractive terms and conditions to AID borrowers. However, to accomplish this, a higher proportion of AID resources will be required for an unguaranteed loan program than for one that is fully guaranteed. Thus, for any given amount of AID resources, less private sector money can be attracted to AID projects.

SUGGESTIONS FOR INSTRUMENT DESIGN

Within the two basic instrument concepts just described, we have identified some specific features that we feel would enhance the viability of a proposed instrument. These features are based upon a broad range of interviews within the U.S. financial community.

The Fully Guaranteed Loan

A program using this instrument should be designed to promote a market perception that the guarantee will be honored promptly and completely in the event of default. If this can be accomplished, the fully guaranteed instrument is likely to elicit broader market interest and more favorable lending terms and conditions. Investors' confidence in the promptness and completeness of guarantee payment can be increased in two ways. First, the guarantee agreement should be drafted to include assurance of prompt and full payment. Second, AID should agree to establish a reserve to back its guarantee. This would not only add a layer of security that would increase investor's confidence, but it would help to reduce legislative resistance to guarantee programs that constitute totally unfunded liabilities.

The Unguaranteed Loan

The design for an unguaranteed loan is far more complex than that of the fully guaranteed loan. Without the guarantee of the U.S. Government, the lender will have a greater interest in examining the creditworthiness of the borrower and in negotiating protection against risk. Therefore, to increase its marketability, we suggest that AID design this instrument to require the type of project evaluation and credit analysis needed to justify a co-financing arrangement from a conventional perspective. Specifically, the unguaranteed lending agreement between the private lender, AID, and the borrowing entity should provide for:

- direct negotiation between the private lender and the borrower;

- borrower participation: providing a full guarantee, paying at least 25 percent of project costs, and ensuring project completion; and

- AID participation: providing a cross-default clause and retaining a disbursement agent.

CONDITIONS FOR PROGRAM DEVELOPMENT

To increase the chances of success, a new AID program of private sector co-financing needs to be a flexible one, allowing for further evolution of the financing instrument, and for expansion of the program from a smaller group of borrowers and lenders to a larger group.

The Initial Program

The program should be established initially as a pilot program of unguaranteed co-financing. AID should carefully select the projects and borrowers to receive financing through the program and the lenders to be approached as program participants. The selection of projects and borrowers should be made consistent with criteria that are most sensitive to the lenders' perspective. The projects should be among AID's larger, more self-supporting, and more revenue-generating projects. The borrowing countries should be among the more creditworthy. At the same time, the lenders should be those most willing to accept risk--commercial banks--lending as individual institutions rather than consortia.

Program Evolution

While the initial pilot program is being implemented, AID may also wish to pursue the authority to guarantee private loans made through the program. Because a full guarantee program is capable of generating greater market interest and better fulfilling AID objectives, it is more desirable than a partial guarantee. However, if it is not possible to obtain authority to offer a full guarantee, a partial guarantee is an acceptable compromise, provided that a high percentage of loss is covered.

As the pilot co-financing program gains acceptance by borrowers and lenders, AID might obtain the authority to fully or partially guarantee private sector loans under the program. Should that happen, the program could be expanded to cover a broader range of projects and borrowers and to provide financing from a greater number of lenders. AID can begin to include projects generating a lower level of revenues in relation to project costs. Borrowers can include countries that are not in the most creditworthy group of LAC countries. Lenders can be expanded to include lending consortia and insurance companies.

The report which follows describes the analysis from which these summary conclusions are drawn. The analysis deals particularly with issues that are sensitive to the development of financial market interest and, as a result, the conclusions are guided first by a market orientation and second by a policy orientation.

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I. INTRODUCTION

The U.S. Agency for International Development (AID) is seeking a new financing instrument that will enable it to attract U.S. private sector funds to its development projects in developing countries. For this reason, AID has engaged Peat, Marwick, Mitchell & Co. (PMM&Co.) and its subcontractor, Brownstein Zeidman and Schomer, to (1) evaluate a wide range of possible financing instruments and (2) develop those instruments that appear most promising on the basis of the evaluation.

BACKGROUND

The need for this study has evolved from a dilemma of increasing seriousness faced by AID's Latin America Bureau. On the one hand, like other U.S. Government organizations, AID must exercise firm control over the expenditure of federal funds, consistent with current and future budgetary limitations in an environment of budgetary restraint. On the other hand, the House of Representative's Committee on Foreign Affairs, has (in its report on H.R. 3324) expressed the opinion that "significantly increased resources should be provided by the United States for development of programs in Latin American and Caribbean countries." The Committee has expressed concern that the proportion of U.S. bilateral assistance flowing to LAC countries has declined from 25 percent in 1973 to 15 percent in the budget proposals currently under consideration. The Committee also notes that this reduced level of assistance has resulted in a sharp decline in net transfers to LAC countries. If the current trend of reductions in assistance continues, "the U.S. bilateral assistance program could become a net drain on development efforts in these countries instead of the contribution to development Congress intended it to be."

While the Committee does not desire a reallocation of resources for fiscal years 1979 and 1980, it does expect that "additional funds will be directed toward Western Hemisphere countries in the period after fiscal year 1980."

Further Congressional consideration of the Committee's proposal is expected this summer. In the meantime, AID is exploring possible approaches to meeting the challenge of expanding assistance to LAC countries without significantly expanding federal appropriations for this purpose. Clearly, this can only be accomplished if AID can arrange to finance some portion of its development program with funds from sources other than the Federal Government. The purpose of this study is to investigate the potential of one such source: private sector investors and lenders in the Unites States.

In addition, this report is expected to provide AID with information useful in its study of U.S. assistance to middle-income countries, a study requested by the Committee on Foreign Affairs in its report on H.R. 3324.

The idea of encouraging private sector financing of activities designed to meet Federal Government objectives is by no means a new concept. F r many years, the government has influenced the domestic and international investment of private funds by means of a variety of direct and indirect mechanisms--from the issue of Federal Government securities, to the provision of tax incentives and federal guarantees of private investments.

Applying such mechanisms to the financing of AID projects has been considered for some time within the Agency. In fact, in 1961, long before the current budgetary dilemma arose, AID began a program to attract private financing to its Housing Guarantee (HG) program. This program, however, cannot be regarded as a near-term response to the current AID financing problem. Because its application is limited by law to housing projects, the HG program cannot be adopted without modification as the new financing instrument sought by the Agency. To expand significantly the level of private sector investment in AID programs, the new instrument must apply to a broad range of AID development projects--projects in agriculture, health, education, energy, environment, and science and technology.

STUDY SCOPE AND APPROACH

As mentioned above, the study has been undertaken to identify a financing instrument that would facilitate U.S. private sector investment in AID projects--beginning with projects located in LAC countries. The approach used in the conduct of the study involved:

- identifying alternative financing instruments for evaluation;
- evaluating those instruments for their capacity to generate market interest, their ability to fulfill AID objectives, and their implementation requirements;
- selecting promising instruments for further development;
- identifying characteristics which should be included in instrument structures in order to promote marketability; and
- preparing suggestions for program development.

By its nature, such an evaluative study is in part predictive. Therefore, the study should not be regarded as a means of guaranteeing the success of any instrument selected. Nor should it be considered a tool for marketing to the investment community any new instrument that AID may select. Instead, the study is expected to assist AID in the selection and initial implementation of a new private sector financing instrument.

Throughout all phases of the study, the marketability of various instrument structures was discussed with representatives of U.S. financial institutions. Interviews were also conducted with international agencies and organizations, so that the consideration of alternative proposals could benefit from prior experience with similar instruments. Attachments A and B, respectively, identify the financial market and governmental institutions which participated in the study.

SUMMARY OF RESULTS

PriMa&Co.'s evaluation of alternative financing mechanisms has led to the selection of two instruments:

- a private sector loan fully guaranteed by the U.S. Government; and
- a private sector loan bearing no U.S. Government guarantee.

The Fully Guaranteed Loan

The fully guaranteed loan is an instrument that is highly marketable, clearly competitive with similar instruments, and capable of fulfilling AID's administrative objectives. It is a low-risk investment with wide market appeal and is likely to attract a variety of investors to the full range of AID projects, in almost any of the Latin American and Caribbean (LAC) countries.

The term and grace period of the guaranteed loan can be designed to meet project requirements. The interest rate charged by the lender can be determined by market conditions for obligations fully guaranteed by the U.S. Government. Under current market conditions, this might be around 9.75 percent. Although this instrument's interest rate, term, and grace period do not provide the degree of concessionality that AID desires, the Agency can increase concessionality by providing its own low interest rate loan to the project. The term and grace period of the AID loan would, again, be determined by project requirements. The interest rate can be set at AID's customary, highly concessional rate of roughly 3 percent. AID and the private investor would participate on roughly a 2:5 ratio for a project with a 20-year repayment period at an 8 percent interest rate to provide a degree of concessionality comparable to that of loans made by the World Bank and the Inter-American Development Bank. To the extent that AID resources are required to establish reserves to back the 100 percent guarantee, this degree of leverage would be reduced.

The primary disadvantage of this instrument lies in the fact that AID currently does not have the authority to provide a full guarantee for projects in areas other than housing. Thus, new legislation would be required before this instrument could be adopted. However, if such legislation were enacted, the remaining implementation requirements would be straightforward in comparison with those associated with instruments not bearing the 100 percent guarantee. The new instrument could be based on the model provided by AID's Housing Guarantee (HG) program. The HG program's contractual formats, relationships with investment bankers, and internal administrative procedures can provide a detailed operational plan for implementation.

The Unguaranteed Loan

The unguaranteed loan has much more limited marketability than its fully guaranteed counterpart. It is also somewhat less likely to fulfill all of AID's administrative objectives. However, it can be designed to provide an equivalent degree of concessionality, and, most importantly, it can be implemented under AID's current authority. Thus, while this alternative lacks some of the advantages of the fully guaranteed loan, its high degree of near-term feasibility makes it a very attractive instrument for further development.

Investors perceive the unguaranteed loan to AID development projects in LAC countries to involve a high degree of risk. Potential investors are likely to be limited to commercial banks, which are more willing to accept this level of risk than are insurance companies and pension funds. Potential borrowers are likely to be limited to those LAC countries that are perceived by commercial bankers as being most creditworthy.

The commercial banks indicated that only under unusual circumstances would they make fixed-rate loans. Instead, the required interest rate can be stated in terms of some premium over the London InterBank Offering Rate (LIBOR) or over the U.S. prime rate. That premium will be determined by the "country risk" and, to a more limited extent, the project risk perceived by the lender. Under current market conditions, this rate might go as high as 13 percent.

The commercial banks also expressed a reluctance to lend under such conditions for a period of more than 6 to 8 years. Under some conditions, maturities might be longer, and grace periods might be agreed to, but such terms would be negotiated on a case-by-case basis. As a result, AID would have to contribute at least 50 percent of the total loan amount to achieve the level of concessionality that it desires.

REPORT OVERVIEW

The chapters which follow elaborate on both the evaluative and the developmental aspects of this study. Chapter II describes the alternative financing instruments that were considered and the criteria by which they were evaluated.

Chapters III, IV, and V present an evaluation of three basic forms of financial instruments. These are, respectively, instruments that are backed by a full U.S. Government guarantee, those backed by a partial guarantee, and instruments or obligations that are unguaranteed by the U.S. Government. These chapters include a discussion of the interest expressed in each of the three forms by the financial community in this country. They also identify promising characteristics, select what we feel is the most attractive combination, and offer suggestions for their implementation.

In Chapter VI, the particular instrument and characteristics selected as the most attractive within each of the three preceding chapters are compared and evaluated, and our conclusions are presented.

II. STUDY DESIGN AND CONTEXT

This chapter describes the parameters within which PMM&Co.'s evaluation of alternative private sector financing instruments was performed. These parameters are of two types:

- the range of alternative instruments to be evaluated; and
- the criteria to be used in performing the evaluation.

ALTERNATIVE INSTRUMENTS

For this study, a diverse set of financing instruments was considered--ranging from a security issued by AID to an unguaranteed loan made by the private sector to a developing country.

The instruments studied are defined by three variables:

- the basic form of the instrument as defined by the nature of the obligation and the role of the issuer;
- the extent to which the U.S. Government shares the private investor's risk by means of a U.S. guarantee; and
- the nature of any additional type of subsidy provided to the borrower by the U.S. Government.

Basic Form

Each of the alternative private sector financing instruments examined in this study can be classified as either a security or a loan. The securities considered were those issued by the U.S. Government or by the borrowing country. The loans considered were those made directly by a private sector lender to the borrowing country. Thus, at most, three basic forms are possible: a U.S. security, a borrowing country security, or a private sector loan.

In the case of an AID security, AID would borrow as a recognized government agency either directly or through the Federal Financing Bank (FFB). Such an instrument bears a full U.S. Government guarantee and would be sold by public offering.

On the other hand, a security issued by a borrowing country or a private loan to the country may or may not bear a U.S. Government guarantee. Such instruments could be sold by public offering under some conditions. However, borrowers not yet established in private capital markets might be limited to access made through private placements.

U.S. Guarantee

The extent to which a new instrument bears some U.S. Government guarantee is the most critical of the three variables defining alternative instruments. AID is seeking a way to provide financing for countries often perceived as high-risk borrowers. Thus, the degree to which the United States can reduce risk is likely to have a significant bearing on the attitudes of potential investors.

The alternative instruments considered in this study fall into three categories with respect to the nature and extent of any U.S. guarantee:

- instruments fully guaranteed by the U.S. Government;
- instruments partially guaranteed by the U.S. Government; and
- instruments bearing no U.S. Government guarantee.

Theoretically, nine possible alternatives are defined by combinations of this variable (U.S. guarantee) and the previous one (basic form). However, only seven of these are realistic alternatives, because the U.S. Government security is implicitly a full faith and credit obligation. As illustrated in Exhibit II-1, our report addresses all seven of the realistic alternatives.

Additional Subsidy

In theory, any of these seven instruments can be accompanied by some additional subsidy designed to reduce the borrower's cost of funds. Such a subsidy could take several forms:

- a tax incentive to the lender, which would increase the lender's after-tax return and at the same time allow for a lower interest rate to be paid by the borrower;
- a direct incentive payment to the lender, paid by the U.S. Government, which would have the same effect as the tax incentive but would operate directly rather than through the federal tax structure;

EXHIBIT II-1

GUIDE TO EVALUATIONS OF ALTERNATIVE FINANCING INSTRUMENTS

BASIC INSTRUMENT FORM		EXTENT OF U.S. GUARANTEE: FULL	PARTIAL	NONE
SECURITY	Issued by AID	Chapter III	Not Applicable	Not Applicable
SECURITY	Issued by Borrowing Country	Chapter III	Chapter IV	Chapter V
Private Sector Loan to the Borrowing Country		Chapter III	Chapter IV	Chapter V

- a <u>direct subsidy paid to the borrower</u> by the U.S. Government, designed to return to the borrower a portion of the borrower's cost of obtaining private sector financing; or

- a <u>co-lending or co-financing</u> arrangement in which AID would make a low-interest loan to the borrower along with the conventional loan from the private sector lender, so that the cost to the borrower of the co-financing package is less than the cost of private sector financing alone.

Each of these approaches can be used to provide any desired level of subsidy. However, only one, co-financing, is clearly within the limits of AID's current authority.

<u>Tax Incentives</u>

At the present time, AID has no statutory authority to grant either a federal tax credit or federal tax exemption to private sector lenders for investing in AID projects. New legislation would be required to provide the authority, by either amending the Internal Revenue Code or amending the AID statute itself to provide for the desired tax incentive. For example, legislation amending the U.S. Housing Act of 1937 (rather than the Internal Revenue Code) has given the Department of Housing and Urban Development (HUD) the authority to confer tax exempt status on Section 8 housing bonds.

<u>Direct Incentive Payment to the Lender</u>

AID currently has no statutory authority for making incentive payments to private lenders or investors, since AID assistance can only be in the form of loans or grants to the foreign borrower for a qualified project. Legislation implementing an incentive program could be modeled after Section 802 of the National Housing Act, which enables HUD to subsidize up to one-third of the interest payable on taxable bonds issued by municipalities to encourage the municipality to avoid issuing a tax exempt bond.

<u>Direct Subsidy Paid to the Borrower</u>

A number of methods could be designed that would allow AID to provide a subsidy to a borrowing country that has agreed to use a conventional loan to fund a particular project. The Agency could provide additional assistance in other areas, an annual grant to cover a portion of the debt service required by the conventional loan, or an additional loan at a low interest rate to be used for repaying the conventional loan.

If the subsidy were designed as a grant, payments could be made for no more than three years due to statutory restrictions on AID grant authority. If the subsidy were made as a loan of the type described above, AID would be open to the criticism that its grant authority was being artifically broadened by means of restructuring grants to qualify technically as loans. Furthermore, in practice there would be little difference between the loan subsidy device and the more straightforward approach involved in a program of co-financing.

A Program of Co-financing

For those assistance programs in which AID is now authorized to make loans, co-financing is possible under existing law. However, certain approaches to the timing of a co-lending agreement are more appropriate than others.

A co-lending agreement may involve one of two patterns of timing for private involvement:

- the AID and private sector loans may be made at the same time; or
- AID may make a loan and then sell participations in that loan to a private sector investor.

PMM&Co. subcontractor, Brownstein Zeidman and Schomer, believes that AID does not have the authority to sell participations in its loans (or to sell its portfolio). Furthermore, such sales may not be practical or of benefit in furthering AID's program responsibilities. First, AID's direct loans generally have relatively low interest rates. Therefore, even if the FFB or an investor were willing to purchase this type of obligation, the loans would have to be sold at a substantial discount to provide a market rate of return. Second, existing laws will not permit AID to retain the proceeds of loan sales for relending purposes. AID would be required to remit such proceeds to the Treasury as "miscellaneous receipts." Finally, the FFB's own enabling legislation provides that nothing therein is to be construed as authorizing a federal agency to increase the amount of obligations it may have outstanding through the use of the FFB as a financial intermediary. New legislation would be required to enable AID to expand its outstanding obligations in this way.

Therefore, the PMM&Co. project team suggests that any AID co-financing program be based on the use of simultaneous lending agreements rather than the sale of participations. As we proceed with our comparative evaluation of fully guaranteed, partially guaranteed, and unguaranteed instruments, whenever it is determined that an additional subsidy is needed, that subsidy will be designed as a simultaneous co-lending program.

EVALUATION CRITERIA: AID ADMINISTRATIVE OBJECTIVES

As mentioned in Chapter I, the criteria used to evaluate alternative private sector financing instruments are: prospects for implementation, capacity to generate market interest, and ability to fulfill AID's administrative objectives.

An instrument's prospects for implementation depend upon two considerations. First, does AID have statutory authority to adopt the instrument, and, if not, what are the prospects that such authority will be granted? Second, assuming AID is authorized to adopt an instrument, what administrative action is required to do so?

An instrument's capacity to generate market interest depends not only on its own characteristics but also on the characteristics of domestic financial markets. Our evaluation of the instruments' capacity to generate market interest is based upon our discussions with representatives of particular investment and lending institutions. This evaluation is presented in the remaining chapters of this report. However, an initial overview of the marketing environment can provide useful insight into the degree of market interest that one might reasonably expect any new financing instrument to generate. Such background information is presented in the next section of this chapter.

This section addresses the third type of evaluation criteria used in this study--the ability of a financing instrument to achieve AID's administrative objectives. The administrative objectives that have been established by AID's Latin America Bureau are of two kinds: programmatic and financial.

Programmatic Objectives

AID's Latin America Bureau is interested in identifying a new private sector financing instrument which can increase the funds available for international assistance. The new financing instrument must be able to utilize AID expertise in terms of the countries to which AID provides assistance, the projects it undertakes, and the administrative role AID plays in the conduct of its assistance projects.

Countries

The Latin America Bureau has indicated that the new financing instrument should have the capacity to make private sector captial available to any of the middle-income LAC countries. This group includes all of the South American countries and most of the Central American and Caribbean countries. The instrument should also be sufficiently flexible to apply to other regions as the new private sector financing program develops.

Projects

AID is interested in attracting private sector funds to borrowing countries on a project-specific basis. The projects supported by the new instrument ideally should include the full range of AID-supported projects. In other words, the Agency wants any project that meets it approval to also be eligible for domestic private sector investment in addition to AID's own participation.

AID's projects involve a variety of subject areas--agriculture, health, education, energy, environment, and science and technology. Many involve infrastructure development such as road building or rural electrification. However, some are designed to support service delivery by the borrowing country, including such activities as agricultural training, family planning, or the support of general education programs.

Some of AID's projects are self-supporting. That is to say, they are eventually likely to generate revenues sufficient to pay project costs. However, most of the Agency's projects are not self-supporting. In fact, many are expected to produce no revenues; they are governmental programs designed to provide a service to the people of the borrowing country and to assist in basic economic development.

Often, AID supports social projects for which the recipient country might not feel justified in borrowing at conventional market rates. As AID pursues alternative financing instruments, private sector lenders or investors may have to be introduced to the financing of particular types of public projects that might otherwise be outside the range of alternatives that they consider to be acceptable. However, in all cases, AID requires the recipient country to be sufficiently interested in the project that it will (1) provide a full guarantee of project obligations, (2) pay 25% of project costs in currency or in kind, and (3) finance any cost overruns. Thus, it is likely that potential investors will look to the creditworthiness of the borrowing country (rather than an individual project's financial viability) in assessing the quality of a loan application.

AID Administrative Role

The third programmatic objective of a new financing instrument is that it utilize AID's administrative capabilities with regard to the projects financed. This includes approval of disbursements of all borrowed funds, including those provided by a private sector investor or lender. The Agency feels that the control that this closely monitored responsibility provides will both ensure greater investor confidence and support AID's own project management objectives.

Financial Objectives

AID's financial objectives for a new instrument describe the financial and market conditions under which private sources of capital will be made available. The Latin America Bureau has established three such objectives:

- leveraging of AID resources;
- provision of concessionary terms to borrowing countries; and
- establishment of a market in the new instrument.

Leverage

"Leverage" refers to the degree to which given amount of AID resources allocated to a project can be augmented by private sector resources. A leverage ratio of 1:2, for example, indicates that every dollar of AID resources is matched by two dollars of private sector funds.

The new financing instrument should provide for maximum private sector participation and, at the least, private sector participation on a one-for-one basis: a 1:1 leveraging of AID's resources.

Concessionary Terms

The concessionality of a loan is the degree to which the terms of that loan approximate an outright grant. Concessionality depends upon the loan's repayment period, its grace period (during which no repayments of principal are required), and the rate at which interest on the loan is paid.

AID wants the new instrument to provide the greatest concessionality possible, but at least at a level comparable to the degree of concessionality normally offered in loans made by the World Bank and the Inter-American Development Bank.

World Bank loans, for example, normally allow a 5-year grace period, a 20-year repayment period, and an interest rate that has generally been in the 7.5 to 8% range. Loans from both the Ordinary Capital Resources and the Inter-Regional Capital Resources at the Inter-American Development Bank are presently available at a 7.9 percent fixed interest rate.

Lending terms this generous are not traditionally available to developing countries from private lenders on a fixed interest basis. However, they may be necessary to allow the debt service requirement to be compatible with a borrowing country's repayment ability. Therefore, a program of co-financing would have to be designed that would combine AID's highly concessional loan with the private lender's market terms and rates to provide the degree of concessionality required: an average grace period of 5 years, a repayment period of 20 years, and an interest rate of 8%.

The interest rate achieved in this way for the co-financing package will be called the "blended" or "combined" cost of funds.

Market Establishment

A final AID objective with regard to financing conditions calls for the new instrument to allow the market of private capital sources to be tapped in relatively small amounts of $5 to $10 million on a recurring basis so that a source of continually available supplementary funds can be developed. Such a condition is desirable to ensure stable support for the proposed program. While the program might start on a very small scale, at perhaps $50 million in AID resources, the financial instrument should be able to support program growth to $200 million or more.

Constraints Posed by Objectives

AID's programmatic and financial objectives pose significant constraints to the development of a successful financing instrument. AID's programmatic objectives call for nearly unlimited flexibility in applying externally generated funds from private sector sources to AID projects in the LAC middle-income countries. The new financing instrument is to apply even to those projects and borrowers deemed least desirable by private investors. Thus, to meet AID objectives, the new financing instrument must be designed to accommodate projects generating no revenues that are located in the least creditworthy of the LAC middle-income countries.

AID's financial objective of market establishment also constrains the development of a successful new financing instrument. Because AID wants the new instrument to provide funds in small amounts ($5 to $10 million), it is unlikely that the instrument can be designed for issue by public offering.

Another significant constraint posed by AID's financial objectives lies in a direct conflict between the objectives of leverage and concessionality. For any given type of financial instrument and any given AID project, an interested private sector lender would require particular conditions that are stated in terms of a grace period, repayment period, and interest rate. These conditions may or may not attain the degree of concessionality desired by AID (concessionality equivalent to that provided by a 5-year grace period, 20-year repayment period, and 8% interest rate). If the private sector offer does not provide sufficiently favorable conditions, then AID resources must be used to make up the balance of concessionality required--via some form of U.S. Government subsidy to the borrower, preferably a co-lending or co-financing arrangement as discussed earlier in this chapter. The degree of AID participation required is directly dependent on the extent to which additional concessionality must be achieved. Thus, the greater the gap between required concessionality and the private lender's offer, the less leverage AID can achieve in the use of its resources. Conversely, for any given amount of leverage that AID requires, only a certain degree of concessionality can be achieved. If less leverage is acceptable then greater concessionality will be possible.

Exhibit II-2 illustrates the way in which reduced leverage is associated with increased concessionality and reduced concessionality is associated with increased leverage. The example in the exhibit assumes that both AID and the private lender are prepared to offer 5-year grace periods and 20-year repayment periods. The private sector is assumed to require an 11% interest rate while AID would make available a concessional 3% interest rate loan. Thus, if AID requires 1:1 leverage, the combined cost of funds to the borrower will be only 7%. However, if AID requires 2:3 or 1:2 leverage the borrower's cost will increase to 7.8% or 8.4%, respectively. Conversely, if AID determines that the minimum acceptable level of concessionality requires a 7% interest rate rather than an 8% rate, then the maximum leverage possible in the example is 1:1.

EVALUATION CRITERIA: DOMESTIC FINANCIAL MARKET INTEREST

Among credit institutions, there is a pervasive attitude of resistance to working with or funding unproven programs, be they private-sector programs or those affiliated with a government agency. AID faces the formidable task of educating this conservative marketplace to recognize the advantages offered by an AID co-financing program. This education process is necessary to develop a broad market constituency, for it is only with the development of this investor group that the most attractive set of borrowing conditions can be obtained.

A new AID program of private sector co-financing would offer two additional uncertainties which could be expected to aggravate the existing market resistance to new programs. The first is the Agency itself--AID's exposure to the financial credit market has been limited to the Housing Guarantee program, which has been accepted by a relatively narrow investor constituency.

EXHIBIT II-2

THE LEVERAGE - CONCESSIONALITY TRADE - OFF

LEVERAGE OF AID RESOURCES	SOURCE OF FUNDS	PERCENTAGE CONTRIBUTION TO COFINANCING PACKAGE	ESTIMATED INTEREST RATE	INTEREST RATE ON ENTIRE COFINANCING PACKAGE
1:1	AID	50%	3%	1.5%
	Private Sector	50%	11%	5.5
				7.0%
2:3	AID	40%	3%	1.2
	Private Sector	60%	11%	6.6
				7.8%
1:2	AID	33%	3%	1.0
	Private Sector	67%	11%	7.4
				8.4%

Assumptions

1. Both AID and private sector lender offer a 5-year grace period and a 20-year repayment period.
2. The private lender requires an interest rate of 11% per annum.
3. AID funds are lent at 3% per annum.

A second uncertainty is the foreign borrower, with whom only a limited number of financial institutions may have an existing creditor relationship. The fact that AID is offering to play an intermediary role is essential and cannot be underestimated, but the Agency must compete with the various multinational development banks if it intends to attract private domestic capital for foreign investment. This is not a broad, well-developed marketplace, and the nature of the "multilateral umbrella" made available by those development banks offers an investor or lender[1] additional security over the bilaterial agreement that would result from a co-financing arrangement undertaken in conjunction with AID.

Furthermore, because the borrower may be a foreign government whose obligations are regarded as high-risk investments, participation by certain investors and lenders may be restricted by law. This section reviews the applicable legal restrictions imposed on the investment portfolios of credit institutions. In particular, the discussion covers restrictions on investments by mutual funds and pension funds, savings and loan associations, insurance companies, and banks.

Mutual Funds and Pension Funds

The mutual and pension funds market represents a tremendous, growing reservoir of investment resources, and federal law imposes no direct restrictions upon the decisions governing their investments. However, managers of these funds are subject to strict fiduciary responsibility as well as to a firm commitment to abide by well-defined limits on diversification and allowable investment quality. In the case of pension funds, most interpretations of the Employee Retirement Income Security Act (ERISA) of 1974 would conclude that foreign securities unguaranteed by the U.S. Government would be incompatible with the conservative investment objectives required by the "prudent man rule" and by the fiduciary responsibility by which they are bound. Furthermore, pension fund managers are sometimes required to invest primarily within this country to best benefit the groups whose funds they are managing.

These managed funds represent primary candidates for foreign obligations that are fully guaranteed by the U.S. Government, but they appear to allow no potential for a partially or a fully unguaranteed foreign security or loan.

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1 The distinction implied by these two terms is as follows. A lender typically will assume an active role in the negotiation of credit terms and in providing continuous and oftentimes formal assessment of the application of such funds (e.g., a commercial bank). An investor, on the other hand, will usually assume a less active role, will represent a different constituent source of funds, and will typically be subject to different yield requirements, greater fiduciary responsibility, and a higher degree of risk aversion.

Savings and Loan Associations

Federal Savings and Loan Associations (S&Ls) may invest in foreign government securities that enjoy a guarantee provided by the Overseas Private Investment Corporation (OPIC) but may not invest in Inter-American Development Bank debentures. They may invest in loans guaranteed under the Foreign Assistance Act of 1961 provided that the loan is 100 percent guaranteed and so long as the S&L's aggregate investment in such obligations does not exceed 1 percent of its assets.

Furthermore, the entire thrift industry (including state-chartered S&Ls and mutual savings banks) is predominantly oriented--both by legislation and by practice--to mortgage investment; while there is limited authority to purchase foreign government obligations, this privilege is seldom used to its limit. While the thrift industry was initially responsible for lending investment support for the Housing Guarantee program sponsored by AID, it probably would not have happened had two conditions, both the housing program application and the full faith and credit guarantee, not been present.

Insurance Companies

The investment portfolios of insurance companies are regulated by state law which varies from one state to another. In general, there are no limitations on insurance companies' purchase of obligations for which principal and interest are secured by an unconditional full faith and credit guarantee of the United States or its agencies or instrumentalities. In addition, insurance companies are normally permitted to invest in obligations of the International Bank for Reconstruction and Development (the World Bank) and the Inter-American Development Bank, subject in some instances to aggregate limits.

Insurance companies chartered in New York may invest up to 1 percent of their "admitted assets" in securities and investments in foreign countries which are substantially of the same kind, class, and investment grades as are eligible for domestic U.S. investments. However, if the company is doing business in a foreign country, it may invest in that country's securities up to 150 percent of its reserves on obligations under contract in that foreign country.

For insurance companies domiciled in Wisconsin and Connecticut, investment in foreign securities may account for as much as 2 and 8 percent, respectively, of "admitted assets." However, most of the large insurance companies interested in doing business in New York, will nonetheless limit their international diversification voluntarily so that they remain within New York's 1 percent-of-assets restriction.

Banks

As a general rule, there are no limits imposed by federal or state law upon a bank's purchase of obligations for which principal and interest are secured by an unconditional full faith and credit guarantee of the United States or its agencies or instrumentalities. Furthermore, banks may, for the most part, purchase obligations of the World Bank and the Inter-American Development Bank, subject in some instances to aggregate limits based upon a percentage of assets or deposits.

Further restrictions on banks' foreign investment portfolios vary with the regulatory body responsible for overseeing bank investments. Therefore, three categories of banks are discussed below: national banks, Federal Reserve member banks, and state-chartered banks.

National Banks

There are no general prohibitions which limit a national bank's ability to loan to foreign governments, their agencies, or instrumentalities, except that such loans to any single country may not, in the aggregate, exceed 10 percent of the bank's capital and surplus. Foreign governments and their related entities are regarded as the same borrower for the purposes of this limitation, except for cases in which an agency or instrumentality of a foreign government can demonstrate sufficient resources or revenues to service particular debt obligations, exclusive of payments by the foreign government.

Restrictions on national banks' foreign investments (as distinguished from loans) are discussed below.

Federal Reserve Member Banks

Under Section 9 of the Federal Reserve Act, state member banks are subject to the same restrictions as are national banks with respect to purchasing, selling, and holding "nonspeculative investment securities." If no U.S. Government guarantee is present, securities of foreign governments or their agencies or instrumentalities are classified as Type III investment securities, which define a group that is not otherwise classified by the Comptroller of the Currency. A national or state member bank's total aggregate investment in this type of obligations is limited to 10 percent of the bank's paid-in capital and surplus. The extent to which a particular security issued by a foreign government meets the definition of "investment security" and is nonspeculative must be determined by the individual bank.

State Banks

The limitations placed upon allowable investments by non-Federal Reserve member state-chartered banks in purchasing the obligations of foreign governments are generally more severe than are those in effect for the national banks. These restrictions demonstrate great variability depending upon the state in which the institution is domiciled. For instance, state-chartered banks in Michigan and Illinois are subject to no statutory limit on their investment in obligations of foreign borrowers. State banks in Texas and Florida are subject to the same limitations on foreign investments as are national banks.

New York bank and trust companies are explicitly limited in their ability to purchase foreign government obligations for investment--except for specific statutory authority to invest in Canadian and Israeli obligations. Up to 2% of an institution's assets may be invested in such an interest-bearing obligation payable in U.S. funds, if the obligation has one of the three highest ratings at the time of investment. Many foreign countries may not be able to obtain such a rating. Other obligations not specifically authorized for investment by statute may be purchased in an amount not to exceed, in the aggregate, the lesser of 1% of the bank's assets or 10% of its net worth.

California statutes setting forth the investment powers of state-chartered banks are extensive. Nevertheless, the only foreign government obligations specifically mentioned are those of Canada, Israel, and Mexico. These obligations, to be eligible for investment, must be payable in U.S. dollars, and the foreign issuer must not have been in default on any of its obligations for more than 90 days during the preceding 10 years. A "basket" provision, however, permits a California bank to invest up to 2% of its deposits in "other securities" if, in its informed opinion, it is prudent for the bank to so invest depositors' funds. Presumably, investments in other foreign government, agency, or instrumentality obligations made under this authority would have to meet the same criteria as those of Canada, Mexico, and Israel.

SUMMARY

A review of the statutory restrictions indicates that there are no federal or state limitations on the purchase of foreign government obligations fully guaranteed by the U.S. Government. However, the ability of potential investors to purchase a partially guaranteed or unguaranteed obligation is more restricted. Mutual funds and pension funds are bound by the "prudent man rule" which substantially limits the extent to which they would be interested in such investments. Federal S&Ls are basically precluded from investing in foreign obligations that do not carry the full guarantee of the United States.

Insurance companies and banks have somewhat greater freedom to invest in foreign obligations of acceptable quality, even in the absence of a full U.S. Government guarantee. Such investments are, in the aggregate, generally limited to 1 percent of assets for insurance companies.

Bank investments in these and other Type III investment securities are generally limited to 10% of paid-in capital and surplus. National bank loans (as distinguished from investments) to any single borrower are also limited to 10% of capital and surplus.

In practice, the smaller commercial banks and life insurance companies do not chose to diversify into international investments to the full extent that they are authorized. Many of the large life insurance companies, however, are very definitely restrained by the 1% limitation that most abide by, and some large commercial banks' interest in loans to particular countries is also restricted by the 10% of paid-in capital and surplus limitation on loans to a single borrower.

III. FULLY GUARANTEED OBLIGATIONS

In this chapter, the alternative forms of an instrument backed by the full faith and credit of the U.S. Government are evaluated. Each form is looked at from the perspective of the financial market interest that could develop for it and its ability to fulfill AID's stated objectives. In the last section of this chapter, one of these fully guaranteed alternatives is selected from among this group as having the greatest ability to be implemented into a workable program.

BASIC FORMS

There are three basic forms of fully guaranteed obligations that AID might wish to incorporate into a program to attract private sector funds to its administered projects. These include (1) the development of an AID agency security, (2) the provision of a U.S. Government guarantee behind the security issued by a borrowing country, and (3) the provision of such a guarantee behind a loan made by a U.S. lender to that borrower.

The AID Agency Security

The design of an AID agency security might incorporate many of the characteristics of those used by other government agencies that are authorized to borrow to finance particular defined activities. This kind of program would come under the control of OMB's credit budget management. Among the agencies that have used this independent access to private capital markets are the Federal National Mortgage Association (FNMA),[1] the Federal Home Loan Bank Board (FHLBB), the Federal Land Bank, and the Tennessee Valley Authority (TVA).

Other agencies borrow directly through the FFB. These include the U.S. Postal Service, the U.S. Railway Association, and the TVA. Some agencies generate funds by selling their assets to the FFB; these include the Rural Electrification Administration (REA), OPIC, Small Business Administration (SBA), and Farmers Home Administration (FmHA).

All of these agencies are able to perform a market-intermediary function that allows them to apply borrowed capital (made available either by direct

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[1] Although FNMA is not actually a government agency, it does borrow within the capital markets with privileged "agency" status.

access to the capital markets or by borrowing from or selling assets to the FFB) to certain purposes, such as mortgage or export credit, or for capital development of certain private sector projects. However, the purposes to which these borrowed funds are put are often by their very nature self-supporting. The use of the agency security thereby allows funds to e obtained from the capital markets at a cost or interest rate that is substantially less than what might otherwise be available for these activities.

The cost of borrowed funds to these agencies is traditionally defined in terms of some premium over the cost of Treasury obligations of a comparable maturity. Long-term Treasury bonds currently trade at a yield of about 8.90 percent. The amount of the required premium over this rate will be influenced predominantly by the investment community's familiarity with the agency's debt and by the liquidity allowed by the secondary market activity in that agency's securities.

This alternative would fulfill all of the Agency's stated objectives, if the legislative authority were available. The cost of these borrowed funds would require a yield that is somewhere near or above the cost at which other established U.S. agencies borrow. Under current market conditions, this would be in the range of 9.0 to 9.1 percent for a 20-year agency security. This represents a spread of about 10 to 20 basis points over yields on Treasury obligations, although this premium might be higher for the more illiquid security of a narrowly traded, unfamiliar agency issuer.

There are two particularly attractive features of the AID agency security alternative. First, it can function as an entirely self-sustaining source of funds. By using loan fees and by relending these funds at a cost that is slightly above its own cost, AID can generate sufficient income to offset its borrowing cost and the cost of some of its own administrative expenses.

Secondly, AID's own immediate access to these funds allows it to direct the money to any country or project that it feels is a justified recipient. This allows AID full flexibility in administering to a wide range of programs with these additional sources of capital, and implies that an investor in these obligations would not look past AID and the full U.S. Government guarantee in evaluating the investment risk.

A Guaranteed Security of a Borrowing Country

This type of guaranteed instrument would allow a borrowing country to issue securities in its own name (either publicly offered or privately placed), but those who invest in these securities would require a yield that is determined by the U.S. Government guarantee and not by the creditworthiness of the borrowing country. This guarantee of another borrower's obligation is a less common type of arrangement for the U.S. Government, although the Title XI Ship Financing Program sponsored by the Maritime Administration (MarAd) of the Department of Commerce provides an example of how it might function. This program provides for a full U.S. Government guarantee for the sale of bonds by U.S. citizens to finance the construction of eligible vessels, but currently no guarantees of another country's issued securities (as opposed to its loans) are outstanding.

With three exceptions, a program of this design would achieve nearly the same objectives as would the AID agency security instrument. First, such a security (issued, for instance, by Colombia and backed by a full guarantee of the governments of both Colombia and the United States) would require a yield or cost to the borrower of something greater than the cost to AID of issuing its own securities. Although the two U.S. Government guarantees might be identical, the securities or private placement market would perceive a distinction by recognizing Colombia as the primary obligor.

Furthermore, a lack of familiarity on the part of the financial community with either AID and its guarantee program or with Colombia could be overcome only through the mechanism of a higher required yield on such a guaranteed security. It would be difficult to estimate the amount of premium that would be required, but this amount would be even more of a variable due to perceived differences which the securities market might observe in the guaranteed (by the U.S. Government) obligations of a Colombia security vis-a-vis those of a much less stable or less creditworthy country. As a result, despite the provision of a U.S. guarantee, these securities originating in different countries might be priced differently by investors.

A third distinction between this alternative and the AID agency security instrument is that it requires establishing a disbursement agent[1] to administer to the proceeds of the security sale. AID has indicated an interest in retaining responsibility for or final approval over the disbursement of all funds associated with a new financing instrument. This alternative might necessitate the creation of such an agent's role.

A variation of this would be the adoption of a program that is similar to the Title XI Program which allows MarAd, acting as its own disbursement agent, to invest, through the Treasury Department, the proceeds of the bond

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[1]A disbursement agent would be responsible for disbursing proceeds of a debt obligation over time as contractually specified conditions are met by the borrower. Financial institutions could serve as disbursement agents under a new AID private sector financing program.

sales that are available during the construction period. If AID decided to use the proceeds of such a guaranteed security sale to fund a program with a long draw-down period (that is, a long period during which total funding would occur), then the reinvestment capability made possible by a program such as this would become important.

The need for a disbursement agent imposes a marginal cost upon the guaranteed security instrument, but it further requires that the borrowing country agree to allow the funds for which it has obligated itself to be turned over either to AID, or to that agent who is subject to AID's approval, and not its own. This need for a disbursement agent and the agreement of the borrowing country to subscribe to the conditions of such a program are common to all the subsequent proposed alternatives.

Despite some of these shortcomings, a borrowing country's guaranteed security would allow for the development of a further advantage. Such a program could provide a vehicle to allow developing LAC countries initial access to U.S. capital markets. The need for a mechanism to provide this initial step was emphasized in the report of the Development Committee.[1] There, the Committee admitted that the investment community's overall lack of familiarity with foreign obligors has barred the access of all but a few of the wealthier and more industrialized countries to the domestic international bond market. This program would allow some foreign borrowers to establish an initial track record of repayment and creditworthiness which is essential to the development of their long-range debt strategy.

Furthermore, the development of a publicly issued security of a less developed country that is guaranteed by the U.S. Government opens the door to possible access to foreign sources of private capital. Under some circumstances, this type of security might be attractive to private investors resident in the borrowing country or the LAC region who would not otherwise purchase securities lacking a U.S. Government guarantee. The investigation of marketability among foreign sources of capital has not been included within the scope of this study, but the potential for tapping foreign credit markets gives the fully guaranteed security of a borrowing country a particular advantage.

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[1] Developing Country Access to Capital Markets, Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries (Development Committee), November 1978.

A Guaranteed Loan to a Borrowing Country

This form of a fully guaranteed instrument is more common within the framework of existing government programs than is the guaranteed security proposal. Similar programs include the Department of Transportation's Aircraft Loan Guarantee program, the Department of Defense's Foreign Military Sales program, the guarantee that is provided for loans to Small Business Investment Companies (SBICs), the Department of Health, Education and Welfare's Student Loan Guarantee program, and even the existing Housing Guarantee program that is sponsored by AID to provide private sector funds to shelter-related projects throughout the world.

HG loans represent an interesting model for any additional AID program. Authority for such a program was initially provided for in the Foreign Assistance Act of 1961, and has subsequently been expanded. Through the use of a full faith and credit guarantee of the U.S. Government, which provides for prompt repayment in the event of default, private sector lenders make available long-term financing for the development of shelter and related urban activities. These loans are typically made for 20 to 30 years at interest rates comparable to current domestic mortgage rates. AID charges a 1 percent initial fee (up to $100,000), and a one-half percent annual charge (assessed on the unpaid balance) both to cover operating expenses and to supplement a revolving reserve fund.

These guaranteed loans have developed a definite market appeal. They are currently publicly underwritten and sell at a premium yield of about 75 basis points over long-term Treasury securities. Initially, these loans had been purchased almost exclusively by or for sale to domestic thrift institutions, but they are now also attractive investments to trust and pension funds and some life insurance companies, which recognize them as something similar to a high yielding Treasury security.

It is important to recognize that the ability of the HG program to access private sector sources of capital is determined solely by the full faith and credit guarantee that is behind it. Without this unconditional guarantee, these loans would be difficult, if not impossible, to market and, if sold at all, they would require substantially higher yields.

Because it allows a guarantee to be made available to the loan of a third-world country, this alternative is similar to the guarantee that the World Bank is authorized to issue. Under that program, the World Bank can guarantee both the securities and the loans of member countries, but this authority has been employed in only one instance. The Bank is reluctant to use it because it must recognize such guarantees as liabilities in the same way that it recognizes its own obligations. As a result, the World Bank's resources are not expanded by its ability to offer such guarantees. In fact, a country would be able to borrow funds at lower cost if it were to borrow directly from the World Bank, rather than borrow by the use of the Bank's guarantee.

The Inter-American Development Bank has also been encouraged to guarantee the loans or securities of some of its member banks, and has successfully resisted doing so for the same reasons as the World Bank's. The Inter-American Development Bank would also be required to commit a portion of its callable capital equal to the amount of the contingent liability created by the guarantee. This would limit its borrowing authority and its own lending ability.

These problems of accounting for the liabilities created by these guarantee programs would not necessarily be shared by either AID or the U.S. Government. However, the legislation necessary to authorize AID to make such a guarantee available would possibly involve two particular restrictions upon the flexibility that such an instrument would allow AID.

First, such legislation might require that a reserve be established to assure lenders of prompt payment in the event of default. For instance, if AID were given authority to guarantee the obligations of borrowing countries for up to $100 million, a reserve of $5 million might be required. Were this $5 million not appropriated as a part of the guarantee authority, AID might be required to contribute the amount from its own budgetary resources. As a result, such a requirement would limit AID's other budgeted activities and would lower the leveraging capability provided by this guarantee program.

Second, the legislation needed to authorize guarantee authority might also require that an annual guarantee fee be assessed the borrowing country. The purpose of such fees would be to accrue into the reserve to make the program more self-supporting. However, such a fee would represent an additional cost that would diminish the degree of concessionality made available to the borrower. As a result, even approval for a fully guaranteed program might include restrictions upon the flexibility allowed AID.

However, the establishment of a reserve, even if it must be initially funded by AID, would achieve two important results. First, it would add to the assurance perceived by the investment community that timely payment of claims could be made. Second, the funding of a partial reserve would help reduce possible legislative resistance to approval for this program, because it would represent less of an unfunded liability.

MARKET INTEREST

Throughout a wide range of interviews that included investment banking firms, life insurance companies, commercial banks, and pension managers, the consensus was that the provision of a full U.S. Government guarantee would attract the broadest market support and would provide AID with a supplementary source of funds at the lowest possible interest rate. Domestic credit markets, and even foreign markets, are familiar with a wide spectrum of U.S. Government guarantee and insurance programs; as a result, there would be little of the "threshold" problem that typically accompanies the development of a new financing program. This is a particularly important point in view of the fact that the purpose of this program is to attract private sources of capital to foreign countries that might otherwise encounter much greater market resistance.

Each of the three forms of fully guaranteed instruments would benefit from nearly the same favorable market reception. For instance, the development of an AID agency security would entirely preclude any concern about the purpose to which the borrowed funds would be put by AID. This would allow these new securities to be traded at yields more closely equivalent to other agency securities. In the course of the interviews, the opinion was often voiced that any reference to Latin American countries would provoke at least some market resistance that even a full U.S. Government guarantee could not entirely eliminate.

Because the name of an eventual Latin American or Caribbean borrower would be absent from it, only the AID agency security among the three instruments would be fully fungible with earlier issues. This would encourage the development of a more efficient secondary market in the securities and would provide greater liquidity for the investor.

This does not imply, however, that either the guaranteed security or loan of the borrowing country would be that much less desirable from the financial community's perspective. Both could be marketed through the efforts of an investment banker in a way that is similar to that used by the HG program, and both would help ensure the development of a relationship between the borrowing country and domestic sources of capital. Over the long term, this relationship might provide the borrowing country with additional benefits.

Both the guaranteed security and the guaranteed loan would require a somewhat higher yield than that necessary to sell the AID agency security. For instance, the HG loans were sold at a yield of about 9.7 percent at a time when agency securities of comparable maturity were yielding about 50 basis points less. The higher yield required on the HG loans, however, has allowed that program to develop the continued interest of a group of investors (savings and loans, pension funds, and in some situations, private individuals) who are particularly attracted to the premium that this fully guaranteed loan offers. A guaranteed loan or security of an LAC country could probably expect this same premium requirement, but such an instrument would be assured adequate market interest.

Within this evaluation of market interest, it is important to recognize that all of the guaranteed obligations discussed in this chapter would also be eligible for sale to the FFB. Particularly in the case of the guaranteed loan or security of another country, a sale to the FFB would permit a significant reduction in the cost of funds that could eventually be passed on to the borrowing country. This approach would permit AID to combine a number of borrowing country debt instruments into one pool and sell that pool to the FFB as a guaranteed obligation. However, this alternative does not allow the borrower to develop a direct relationship with the investment banking community, which both AID and some borrowers would find desirable.

IMPACT ON AID OBJECTIVES

There is little difference among these three fully guaranteed instruments in their ability to attain the full array of financial objectives that AID has established. For instance, each would find broad market appeal and would permit the development of a continuous access to private sources of funds that would be nearly uninterrupted by swings in the domestic credit market cycle. Each of the instruments would allow for fixed-rate financing at almost any maturity, and each gives AID the possibility of leveraging its own resources by at least the 1:1 relationship that it has asked for while maintaining an acceptable degree of concessionality for the LAC country.

For instance, in current credit markets, an AID agency security might require a return of about 9.1 percent, and the sale of a guaranteed security or loan might necessitate a yield of about 9.75 percent. These are only estimates made in a very unusual credit market period, but they serve the purpose of demonstrating the degree of leverage that would be possible at a combined 8 percent cost of funds. This rate represents the degree of concessionality that AID has defined as a baseline because it is somewhat comparable to terms available from the World Bank.

Exhibit III-1 demonstrates that the development of an AID agency security would allow for a leverage of nearly 1:5 and still provide an 8 percent blended cost of funds to a borrower. Because the guaranteed loan or security would provide private sector funds at a cost of about 9.75 percent, it would allow for approximately 1:3 leverage when coupled with the 3 percent concessionary resources that AID has at its disposal.

EXHIBIT III-1

LEVERAGE AND CONCESSIONALITY WITH A FULL GUARANTEE

TYPE OF GUARANTEED INSTRUMENT	AID AGENCY SECURITY	GUARANTEED LOAN OR SECURITY OF A BORROWING COUNTRY
Cost of Concessionary AID Funds (Prorated Cost)	3.0% (3.0 x .1667) = 0.50%	3.0% (3.0 x .25) = 0.75%
Cost of Guaranteed Funds (Prorated Cost)	9.1% (9.1 x .8333) = 7.58%	9.75% (9.75 x .75) = 7.31%
Blended Cost	8.08%	8.06%
Allowable Leverage	Nearly 1:5	Nearly 1:3

The exhibit indicates that each of the three fully guaranteed alternatives would be adequate to fulfill the financial objectives established by AID. However, there is a more definite difference among the three in their ability to fulfill AID's programmatic objectives. Only the agency security can assure the use of AID's project administration capabilities, and only this one permits the unrestricted application of funds to all AID projects and programs in a full range of LAC countries.

The fully guaranteed security and the loan are similar in their ability to fulfill these objectives: both are more limited than the agency security in allowing AID total flexibility in providing financing to all projects and all countries. More importantly, they each necessitate the use of a disbursement agent, a requirement that may meet some resistance on the part of a borrowing country.

Interviews with lenders and investors further indicated that there is a formidable reluctance to purchase obligations, regardless of the extent of U.S. Government guarantee, that are very small (up to $5 to $10 million range). This is considerably more of a problem when there is no full guarantee provided by the U.S. Government, because it necessitates a more detailed and critical project evaluation and analysis of country credit. If AID were to issue its own securities, and use the proceeds to fund projects in particular countries, this would present no problem. But if a number of countries were to offer obligations in very small amounts, the financial community would be less interested.

SELECTION AND IMPLEMENTATION

Were AID given full authority to develop a cofinancing program that could call upon a full U.S. Government guarantee, any one of these three instruments would be a viable and an attractive alternative. However, the use of any of these three instruments requires legislative action to provide the necessary authority. Except in the narrowly defined circumstances relating to its HG program, AID currently has no authority to issue or make available a full guarantee for its own security or for the security or loan of an LAC country.

If the House of Representatives and the Committee on Foreign Affairs are successful in carrying out the proposed objective of "significantly increased resources for development programs" in the LAC countries, then the use of AID's own financial and administrative resources would provide a very convenient and flexible vehicle for implementation. The development of an approved guarantee program would permit AID to funnel private funds into the same countries, achieving many of the same objectives at a much lower cost to the U.S. Government than that required for direct foreign assistance.

Officials in the Department of Treasury and the Office of Management and Budget (OMB) have indicated that there is significant resistance to what is viewed as the increasing use of "back door" financing through guarantee programs that fall outside of budgetary limitations. This reflects a common attitude within both the Executive and the Legislative Branches that all government expenditures should be brought under budget authority and the growth of unfunded liabilities should be contained. In fact, OMB Circular A-11 issued in May of this year recommended that all guarantee and insurance programs be approved by an appropriations committee. Should such a recommendation be implemented, it may be very difficult for AID to secure guarantee authority without having to give up appropriations for its grant or loan programs.

On the other hand, a proposal allowing AID authority to guarantee the loans of LAC countries might find the most support when it is presented as a viable and established channel for offering economic assistance. Such a channel would be much more efficient and less costly to the U.S. Government than an alternative package of direct foreign aid. And in the same light, any one of the three guaranteed alternatives considered in this chapter could be designed to reduce both the cost and risk that might be borne by the Federal Government.

To the extent that proceeds from the sale of a guaranteed obligation are leveraged with AID's own concessionary funds, this combination would provide the least costly combined source of funds to the borrower. If, however, the obligations were in the form of an agency security, AID would be in a position to "relend" its borrowed funds to an LAC country at a sufficiently high rate (at some "spread" over its own cost) to cover the Agency's own interest and expense and to offset incurred administrative costs. This market intermediary function could be performed on a self-sustaining basis whereby payments made by borrowing countries would be adequate to allow AID to repay interest and eventual principal on its agency security.

In the case of a guaranteed loan or security of another borrower, AID would have no opportunity to benefit from a favorable spread. Instead, participation or guarantee fees could be assessed the borrower. These could be designed to provide an adequate source of income to offset operating and administrative expenses in a way similar to the self-supporting character of the HG program.

Any of these guaranteed financial instruments could therefore be designed as a self-supporting program. However, the program must also be designed to substantially reduce the expected loss due to default and to limit the potential liability assumed by the U.S. Government. To some extent, AID can accomplish this by prudent and responsible selection of projects and countries that reflect a very low probability of eventual default. Being selective will limit the latitude of projects eligible for AID's guarantee program, but it may be necessary if a convincing argument is to be presented to Congress that the program would be a low risk one.

In theory, then, the cost and risk inherent in developing a guarantee program should not necessarily discourage support for one of these three alternatives. It is possible that the instrument can be designed to incorporate no subsidy on the part of the U.S. taxpayer over and above the concessionality that AID is otherwise authorized to provide.

The concerns expressed by Treasury and OMB about a proliferation in the use of guarantee programs are legitimate ones, and it may be disadvantageous for AID to seek any form of guarantee authority at this time. However, the merits of AID's use of such guarantee authority may be justifiable in terms of other national objectives, and these may be adequate to offset the disadvantages that might be perceived in providing such authority.

One aspect of the full guarantee program which should be carefully designed is the provision for the manner in which the guarantee will be honored. During the course of our interviews with investors and lenders, concern was expressed for promptness and completeness in honoring the full U.S. Government guarantee. Problems with other U.S. guarantee programs (in particular, SBA and OPIC programs) were cited as instances in which investors have been disappointed in the United States' performance in honoring its guarantees. Investors also felt that a full guarantee program should not require forbearance when there is adequate justification to call a default. Guarantee payments on losses of principal and interest should be paid promptly when the conditions defining default are present--even if the borrowing country expresses a willingness to resume its repayments at a later time.

Finally, the question is sometimes raised as to whether allowing additional guarantee programs triggers an imbalance within the credit markets. It is sometimes suggested that a new source of demand for guaranteed funds pushes up the overall cost of all other "agency" or "guarantee-privileged" borrowers. This argument was used to criticize the impact upon the tax-exempt market of the municipal mortgage revenue bond issues, but one cannot conclude that a guaranteed AID financing program would effect a similar result. The overall size and liquidity of the agency securities market, which includes issues from such sources as the Federal Land Bank, FNMA, FHLBB, FmHA, SBA, and numerous others, makes that market rather insensitive to the issuance of additional government guaranteed loans or securities which AID might sponsor at a pace of far less than $100 million annually.

If AID were to decide to seek Congressional approval authorizing one of these fully guaranteed instruments, the development of the fully guaranteed loan appears to be the easiest to implement. Exhibit III-2 presents a framework for evaluating these three alternatives, and demonstrates that even the AID security does not have a clearly defined advantage over either of the other instruments. However, while the guaranteed loan does not offer the complete program flexibility that would be allowed by the AID security, it nearly fulfills all objectives and would allow AID broad latitude in its use.

The guaranteed loan requires a greater degree of commitment and responsibility on the part of the borrowing country, and exposes the borrower to the domestic capital markets in a way that the AID security does not. A guaranteed loan program can also be presented as a logical extension of the HG program. The importance that this existing program has in establishing both the administrative precedent and the immediate vehicle for market access cannot be overestimated. Finally, the guaranteed loan alternative would meet significantly less political resistance than either of the other instruments if a reserve fund were established to ensure prompt payment in the event of default or loss. Besides enhancing investor acceptance, the establishment of a reserve would allow the program to account for at least a portion of the total contingent liability.

EXHIBIT III-2

SUMMARY: COMPARATIVE EVALUATION OF GUARANTEED INSTRUMENT

EVALUATION CRITERION / INSTRUMENT			AID AGENCY SECURITY	FULLY GUARANTEED SECURITY	FULLY GUARANTEED LOAN
MARKET INTEREST			BROAD INTEREST MOST FUNGIBLE SECURITY	BROAD INTEREST LIMITED LIQUIDITY	BROAD INTEREST LIMITED LIQUIDITY
AID ADMINISTRATIVE OBJECTIVES	FINANCIAL	Approximate leverage expected under current market conditions	Very high leverage; nearly 1:5	Very high leverage; possibly 1:3 depending upon reserve requirements	Very high leverage; possibly 1:3 depending upon reserve requirements
		Concessionary terms	Fixed rate, long-term; cost estimated at about 9.1%; very attractive concessional terms	Fixed rate, long-term cost estimated at 9.75%; less if sold through FFB; attractive concessional terms	Fixed rate, long-term cost estimated at 9.75%; less if sold through FFB; attractive concessional terms
		Market establishment	Continuous access	Continuous access; potential for "special market" acceptance	Continuous access; potential for "special market" acceptance
	PROGRAMMATIC	Type of project	Unlimited application	Virtually any type of project	Virtually any type of project
		Borrowing countries	Unlimited application	Nearly any borrowing country	Nearly any borrowing country
		AID Administrative Control	Assured	Virtually assured but subject to borrower approval	Virtually assured but subject to borrower approval
IMPLEMENTATION REQUIREMENTS		Legislative	New authority required	New authority required	New authority required
		Administrative	Would require new resources to implement	Would require new resources to implement	Expansion of HG program concept would facilitate implementation

IV. PARTIALLY GUARANTEED OBLIGATIONS

In Chapter III of this report we discuss possible new financing instruments having a low level of risk: instruments bearing a 100% guarantee backed by the full faith and credit of the U.S. Government. Investors view those instruments as having a risk level associated with the economic condition and political stability of the U.S. Government, the full guarantor of the obligation. Chapter V discusses possible new financing instruments which bear no U.S. Government guarantee. These obligations are perceived by investors as having a much higher level of risk: "country risk," determined by the economic condition and political stability of the borrowing nattion, a developing country.

This chapter addresses possible new instruments bearing a partial guarantee of the U.S. government. Investors can be expected to perceive the risk in this case as being somewhere between the low-risk fully guarteed instruments and the higher risk level of unguaranteed instruments. After an introductory description of the basic forms of the partially guaranteed instrument, this chapter presents our evaluation of such an instrument's capacity to generate market interest and its ability to fulfill AID's programmatic and financial objectives. A concluding section (1) offers our selection of that partial guarantee which has the most promising prospects for generating market interest and attaining AID's objectives and (2) describes the action necessary for implementation.

BASIC FORMS

Obligations that are partially guaranteed by the U.S. Government may vary in form and in the coverage offered by the partial guarantee.

Instrument Form

The instrument backed by a partial guarantee may take the form of either a security issued by a borrower and purchased by investors, or a loan to the borrower made by a party other than the guarantor. Among the partial guarantee programs currently conducted by the Federal Government, the latter is far more common. They include international programs such as those of AID's Productive Credit Guarantee Program (PCGP) and the Overseas Private Investment Corporation (OPIC), as well as the domestic partial guarantee programs of other agencies, including the Department of Agriculture's Farmers Home Administration (FmHA), the Small Business Administration (SBA), and the Veteran's Administration (VA).

Guarantee Coverage

By definition, the coverage provided by a partial guarantee is less than full coverage. Unlike the full guarantee discussed in Chapter III, the partial guarantee will not assure the investor of recovering all of its investment at all times or in all instances of default.[1]

The exact nature of the coverage offered by the partial guarantee may be defined in a variety of ways. Three of the more common types of limits defining partial guarantees are:

- limits on the extent of losses covered;

- limits on the amount of repayments guaranteed; and

- limits on the application of the guarantee to instances of default caused by specified events.

These coverage limitations are not mutually exclusive; all three could, theoretically, be used in the context of a single instrument. For example, a partial guarantee could be structured to cover 75 percent of losses of unpaid principal and interest, to a maximum repayment of 90 percent of original principal, payable only if losses are incurred because of a default caused by war or insurrection in the borrowing country.

In practice, however, the various types of limits defining partial guarantees are often used independently. For example, the FmHA's Business and Industrial Loan and the SBA's Regular Business Loan guarantees cover up to 90 percent of unpaid principal and interest with no restriction on total repayments or cause of default. The VA home loan guarantee program, on the other hand, covers 100 percent of the lender's losses to a fixed maximum amount, which is the lesser of 60 percent of original principal or $25,000. OPIC offers an example of coverage limited by cause of default. OPIC insures U.S. private investment in developing countries against losses due to three types of political risk:

- loss due to inconvertibility of the currency of the country in which investment is made. This coverage also insures against

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[1] Losses may be defined as losses of unpaid principal and interest or of unpaid principal, interest, and expenses.

adverse discriminatory exchange rates, but it does not protect against the devaluation of a foreign currency.

- loss due to expropriation, which may include both nationalization and cases of "creeping" expropriation. OPIC pays expropriation compensation only against assignment to it by the insured of title to the expropriated properties.

- loss due to war, revolution, and insurrection. This does not include coverage against civil strife.

MARKET INTEREST

The value of a partial U.S. Government guarantee on obligations of developing countries varies by type of investor and by type of guarantee coverage.

Type of Investor

Some investors are not interested in conducting the detailed analysis necessary to assess the risk of lending to a developing country. These investors, such as pension fund and mutual fund managers and some commercial bank trust departments, are primarily attracted by highly liquid investments with risk return trade-offs that are easily understood. While privately placed securities are possible, public offerings have a greater appeal to this type of investor because they require no direct negotiation with the issuer of the security and they represent a more liquid form of investment.

Initial interviews with the investment community immediately indicated that these passive investors have little interest in an instrument that is only partially guaranteed by the U.S. Government. Unless the investor had a high degree of familiarity with, and confidence in a borrowing country, he would be unlikely to accept the risk inherent in the unguaranteed loan portion.

On the other hand, other investors are prepared to conduct an in-depth analysis of the borrowing country's creditworthiness. These investors, primarily large commercial banks and some large insurance companies, have made unguaranteed loans to the more creditworthy Latin American and Caribbean countries. Thus, they are also willing to consider making partially guaranteed loans. However, they would closely evaluate the obligor of the unguaranteed portion.

In general, commercial banks respond more positively to the concept of a partial guarantee than do insurance companies. Some insurance companies expressed particular concern for the creditworthiness of many borrowers. Some also question whether the U.S. Government would promptly administer the terms of a guarantee in the event of default. These insurance companies indicate that they would favor a reserve fund held in the United States to cover any late payments by borrowers and to ensure timely guarantee administration. However, the establishment of such a reserve would not necessarily ensure their participation in a new partial guarantee program.

Commercial banks, on the other hand, seemed more comfortable with the concept of a partial guarantee. They are not only less averse to risk than the insurance companies, but are also more accustomed to working with partial guarantee programs. Many have participated in the U.S. Government's partial guarantee programs. Some bankers have indicated that an AID partial guarantee program could be sufficient inducement to lend to a country that would not otherwise qualify for a loan. In particular, this might be the case if the country risk were near the lender's risk limit or if loans to the country were nearing the bank's legal lending limit.

Type of Coverage

Lender interest in the partial guarantee concept also varies according to the type and extent of coverage provided by the guarantee. Variation in lender reaction is discussed below for the three basic dimensions of partial guarantee coverage which were discussed with investors and lenders.

Extent of Losses

Interviews with the financial community elicited mixed reactions with regard to a guarantee that would pay a given percentage of losses of principal and interest. Many lenders pointed out that, with this type of coverage, the loan involved is actually composed of two loans--one which is fully guaranteed and one which is unguaranteed. Reactions of insurance companies ranged from complete disinterest in anything except the fully guaranteed portion of the loan to tentative interest in coverage as low as 50 percent of unpaid principal and interest. However, current experience with such guarantees seems to be limited to partial coverage of no less than 90 percent of unpaid principal and interest, the most common degree of coverage provided through Federal Government programs.

Reactions of commercial banks are generally more favorable. While some express little interest in the percent-of-loss concept, others merely point out that a partially guaranteed loan would be priced as two loans. In cases in which a bank would be willing to make the unguaranteed portion of the loan, at a sufficiently high rate of return, it would be interested in the partial percent-of-loss guarantee as well. The higher the percent of loss covered, the lower the interest rate the bank would be willing to accept.

A guarantee could also be structured to provide variable coverage over time. For example, losses on a 15-year loan could be unguaranteed for the first 5 years, 50 percent guaranteed during the next 5 years, and 100 percent guaranteed during the last 5 years. The insurance company representatives interviewed during the course of this study expressed little interest in this idea of time-variable coverage. However, some bankers reacted more positively. One suggested that it would be acceptable for the loan to be unguaranteed for 3 years, but probably not for 8 years. Nevertheless, such an approach may provide little protection to the U.S. Govenment, as a lender could postpone calling a default until the later years of the loan during which 100 percent of losses would be covered. Only a careful structuring of time-variable coverage can avoid this potential problem.

Amount of Repayments

The amount of repayments of losses under a guarantee can be limited in several ways. The most common approach is to limit repayments to fixed dollar amount, a percentage of original principal, or both.

Insurance companies reactions to the idea of limited repayments were mixed, ranging from complete disinterest to selection of this approach as the best of the partial guarantee concepts. Those companies responding favorably, however, would require a fairly high maximum repayment. For example, one company would consider making a loan bearing a U.S. Government guarantee to pay all losses of principal and interest to a maximum of 90 percent of the original principal.

Commercial bank reactions to percent-of-original principal coverage were generally more positive. Bankers indicated that they would lend at a lower rate with this partial guarantee than they would if their loan were not guaranteed at all by the U.S. Government. Particular interest was expressed in structuring the guarantee so that losses incurred during the last 5 years of the loan would be 100 percent guaranteed. Some bankers also expressed a willingness to consider a postponement of the effective date of the guarantee.

Cause of Default

One variation of coverage based on cause of default was discussed with the financial community during the course of our study. This was political risk insurance, designed according to the OPIC model discussed earlier in this chapter.

The only type of lender which seemed at all interested in political risk coverage was the commerical bank that does not have an established presence in the borrowing country. Large international banks that are already situated in many Latin American and Caribbean countries have assessed the question of political risk and have made the decision to take that risk.

Insurance companies, on the other hand, are generally not interested in situations of high political risk. They would be inclined to assess the political risk of a potential borrower and then to proceed with a loan only in cases where that risk seemed slight. Thus, political risk coverage has little appeal for these investors.

IMPACT ON AID OBJECTIVES

As we have discussed in some detail in Chapter II, AID has a number of programmatic and financial objectives against which the effectiveness of any selected instrument must be measured, however marketable that instrument may be. In general, the partially guaranteed instrument is somewhat less able to fulfill these objectives than is the instrument backed by the full guarantee of the U.S. Government.

Programmatic Objectives

As discussed in Chapter II, AID's programmatic objectives require the new financing instrument:

- to apply to the type of project that AID customarily finances--governmental projects in the areas of agriculture, health, education, energy, environment, and science and technology--many of which generate insufficient revenues to cover project costs:

- to be available to the full range of middle-income countries in the Latin American and Caribbean region; and

- to utilize AID's capabilities and experience in project planning, analysis, and implementation monitoring.

Type of Project

Initially, a number of investors, both insurance companies and commercial banks, expressed the opinion that a partial guarantee by the U.S. Government would not be sufficient to interest them in making loans on projects that are not self-supporting. It was suggested that AID develop a partially guaranteed, private sector, co-lending program applicable only to the larger projects and those capable of generating revenues most nearly adequate to cover debt service.

However, because the borrowing country is willing to provide a full guarantee, most lenders are willing to consider the investment as a "country risk" rather than a "project risk." Thus, the revenue-generating capacity of the borrowing project takes on less importance. Instead, the balance of payments, balance of trade, inflation rate, gross national product, and credit history of the borrowing country are considered the relevant factors to use in assessing the creditworthiness of the borrower.

Middle Income Countries

Insurance company representatives indicated that no partial guarantee would be sufficient to encourage them to lend to a country that is perceived as a high risk from a political or economic perspective. However, a properly structured partial guarantee tailored to the risks associated with the borrower could be sufficient to encourage the companies to lend to some of the middle-income countries with high per-capita GNP that would not otherwise receive financial support from the company.

Commercial bankers are, by and large, somewhat more willing to accept the higher levels of risk under the protections offered by a partial guarantee. In general, they seem more willing to consider a broad range of LAC country borrowers than do the insurance companies.

However, the banks' preferences and interpretations of creditworthiness are by no means uniform. Occasionally, a given country risk seems quite acceptable to one bank and clearly unacceptable to another. Nonetheless, even with a careful matching of lenders and borrowers, we believe that a partially guaranteed instrument will not enable AID to find private sector financing for the full range of middle-income LAC countries.

AID Administrative Role

A partially guaranteed instrument must utilize AID's administrative capabilities--including control over disbursements. However, although some potential investors have noted that they take comfort in AID's administrative participation, others have expressed a preference for avoiding governmental controls on disbursements.

Financial Objectives

AID's three financial objectives for the new financing instrument are:

- to provide to the borrower a degree of concessionality comparable to that made available by World Bank and Inter-American Development Bank loans;
- to provide to AID at least 1:1 leverage of its appropriated funds; and
- to provide for financing on a recurring basis.

A partially guaranteed instrument can be expected to fulfill the third of these three objectives. Once specific commercial banks, and possibly some insurance companies, have some experience with the partially guaranteed instrument and its successful application, they might be willing to continue their participation in the program--barring a significant change in market conditions.

A partially guaranteed instrument probably also fulfill AID's leverage and concessionality requirements. However, as discussed in Chapter II, there is a direct trade-off between these two objectives. The following analysis addresses this trade-off as it applies to the partially guaranteed instrument. The examples used are structured to provide guarantee coverage of 50 percent, 80 percent, and 90 percent of losses of unpaid principal and interest.

For the purpose of this analysis, it is assumed that the degree of concessionality is a fixed requirement, set at the World Bank terms of:

- a 5-year grace period;
- a 20-year repayment period; and
- an interest rate of 8 percent per annum.

To simplify this general analysis of leverage, it shall also be assumed that both private lenders and AID are willing to offer the 5-year grace period and the 20-year repayment period. (However, if the private lender is a commerical bank rather than an insurance company, such terms are very unlikely to be available in practice.)

If the partially guaranteed loan is regarded by the lender as being a combination of a fully guaranteed loan and an unguaranteed loan, the lender's pricing of the loan might be calculated as illustrated in Exhibit IV-1. As shown in the exhibit, the assumption is made that the private sector lender requires a 13 percent interest rate on an unguaranteed loan and a 10 percent rate on a fully guaranteed loan. However, it is important to note that such terms would vary by country, and for some countries, no unguaranteed portion of the loan would be acceptable.

Assuming that AID project resources are available for lending and need not be set aside in a reserve fund, the leverage available to AID through the use of these partially guaranteed instruments can be estimated at approximately 1:2 for the 80 percent and 90 percent guarantees and 5:7 for a guarantee covering 50 percent of losses (see Exhibit IV-2). If reserves were required to back AID's guarantee, this degree of leverage would be reduced as illustrated in Exhibit IV-3.

SELECTION AND IMPLEMENTATION

From among the various types of partially guaranteed instruments discussed in this chapter, we conclude that the most viable for AID's purposes is a partially guaranteed loan that provides a high percentage of loss coverage (at least 80 percent). The choice of a loan rather than a security as the form of instrument is based on our analysis of market interest. Although the potential market is broader for a security than for a loan, securities market investors are less interested in providing development financing to AID borrowers. The choice of high percentage-of-loss coverage is based on its ability to meet AID's financial objectives. As discussed earlier in this chapter, the higher the percentage of loss covered, the greater the leverage of AID resources for any given level of concessionality.

This partially guaranteed instrument could also include additional features such as a limit on repayments or a limit of coverage for political causes of default. Political risk coverage does not appear to be worthy of further consideration, as interviews in the financial community have indicated that it would generate little market interest. However, under certain conditions, it may be worthwhile to adopt a limit on repayments.

Specifically, in the process of developing a partially guaranteed instrument, U.S. Government decision makers may determine that additional protection for the U.S. Government is needed. In other words, it may be necessary for the U.S. to accept a lower level of risk than that associated with a partial guarantee that has only limited percentage-of-loss coverage. If this is the case, then a limitation on repayments should be considered.

EXHIBIT IV-1

PRICING CALCULATION: PARTIALLY GUARANTEED LOANS

	PROPORTION OF LOAN	ESTIMATED INTEREST RATE	ESTIMATED INTEREST RATE FOR THE ENTIRE LOAN
90% Guarantee			
Fully Guaranteed Portion	.90	10%	9.0%
Unguaranteed Portion	.10	13	1.3
Entire Partially Guaranteed Loan	1.00		10.3%
80% Guarantee			
Fully Guaranteed Portion	.80	10%	8.0%
Unguaranteed Portion	.20	13	2.6
Entire Partially Guaranteed Loan	1.00		10.6%
50% Guarantee			
Fully Guaranteed Portion	.50	10%	5.0%
Unguaranteed Portion	.50	13	6.5
Entire Partially Guaranteed Loan	1.00		11.5%

EXHIBIT IV-2

LEVERAGE CALCULATION: PARTIALLY GUARANTEED LOANS

If AID makes its resources available at an interest rate of 3%; and
If X is the proportion of the total financing package that is funded with private sector funds; and
If Y is the proportion of the total financing package that is funded with AID resources; then:

$$X + Y = 1$$
or
$$Y = 1 - X$$

Thus, for the 90 percent guaranteed loan:

$$X\,(10.3\%) + Y\,(3\%) = 8\%$$
$$X\,(10.3\%) + (1 - X)\,3\% = 8\%$$
$$.103X - .03X + .03 = .08$$
$$.073X = .05$$
$$X = 68.5\%$$
$$\text{and} \quad Y = 31.5\%$$

For the 80 percent guaranteed loan:

$$X\,(10.6\%) + Y\,(3\%) = 8\%$$
$$.106X - .03X + .03 = .08$$
$$.076X = .05$$
$$X = 65.8\%$$
$$\text{and} \quad Y = 34.2\%$$

For the 50 percent guaranteed loan:

$$X\,(11.5\%) + Y\,(3\%) = 8\%$$
$$.115X - .03X + .03 = .08$$
$$.085X = .05$$
$$X = 58.8\%$$
$$Y = 41.2\%$$

EXHIBIT IV-3

APPROXIMATE DEGREE OF LEVERAGE BY RESERVE REQUIREMENTS AND BY EXTENT OF PARTIAL GUARANTEE

	EXTENT OF PARTIAL GUARANTEE		
	90%	80%	50%
No reserve	1:2	1:2	5:7
25% reserve*	2:3	3:4	5:6
50% reserve	10:11	12:13	19:20
100% reserve	4:3	4:3	6:5

*Reserve requirements are expressed as a percentage of the guaranteed portion of the private sector loan.

Commercial lenders and some insurance companies have expressed an interest in a guarantee with coverage that increases over time. A limit on repayments would provide such coverage. If such a provision is adopted, then the maximum repyment should be set at a level high enough that, in the later years of the loan, repayment at the selected level of percentage-of-loss coverage will be less than the maximum repayment amount allowed.

The implementation requirements of a partially guaranteed instrument are similar to those necessary for the fully guaranteed instrument. In both cases, legislative change is required as well as administrative change.

Legislation

Just as AID is not authorized to provide full guarantees for any projects other than housing projects, it is not authorized to provide a partial guarantee of obligations held by U.S. investors, regardless of type or extent of coverage. Thus, before AID could offer a partial guarantee, new legislation would have to be passed by Congress and signed by the President.

As discussed in Chapter III, prospects for new legislation authorizing a full guarantee program are not good. However, support for a partial guarantee is more likely, particularly if a partial reserve fund is established to back the guarantee and the program is developed consistent with guidelines currently under consideration by Congress.

Administrative Action

The administrative implementation of a partial guarantee program is likely to be somewhat more complex and costly than that of a full guarantee program. While AID could benefit from the experience of other U.S. Government agencies with partial guarantee programs, the Agency itself has no existing activity which provides a close model for program development. Some aspects of the PCGP and HG programs can be adopted, but neither provides a model that is directly responsive to the requirements of the new partially guaranteed instrument examined in this study.

Furthermore, any partial guarantee will require more detailed negotiation between borrowers, private sector co-lenders, and AID than would be required in the case of a full guarantee. Therefore, AID's central office staffing requirements and other expenses would be greater for a partial guarantee program than for a full guarantee program.

V. UNGUARANTEED OBLIGATIONS

If Congress allows no form of a U.S. Government guarantee to be attached to an obligation associated with an AID project, then a borrowing country would be forced to accept the terms and restrictions that lenders or investors impose in the normal course of their lending or investment process. That is, any concessionary funds provided by AID would be supplemented only by funds made available from a commercial source at full market rates. As a result, the alternatives discussed in this chapter would have a more difficult time fulfilling objectives that are important to both AID and to the borrowing country.

As was mentioned earlier, AID requires that a host country provide at least 25 percent of the entire cost of a program or project, either in currency or in kind. While it is likely that AID's presence and this financial commitment by the borrower would reduce some of the inherent risk perceived by a lender or investor, there will be some instances in which the problems associated with this risk cannot be overcome. An unguaranteed instrument would require domestic financial institutions to underwrite a combination of types of political risk as well as the risk that a stable and friendly relationship between the borrowing country and the U.S. Government might be terminated. As a result, these institutions will be very cautious and particularly selective about which countries they might choose to lend to.

Two basic forms of unguaranteed obligations are discussed in this chapter. Following a description of each, and of the market interest that each could expect, their impact upon AID's objectives will be evaluated. At the end of this chapter, suggestions concerning unguaranteed instruments are presented along with a plan for implementation.

BASIC FORMS

The alternatives considered in this chapter include securities issued by and guaranteed only by an LAC country, and loans made to that country having no guarantee beyond that of the borrowing country.

The Unguaranteed Security

Within the framework of this discussion, it is important to recognize that a reference to an unguaranteed instrument means only that there is no additional full or partial guarantee provided that instrument by the U.S. Government. In all cases, be it either a security or a loan, a full 100 percent guarantee by the borrowing country will stand behind the obligation.

The report of the Development Committee details the limited success that Third-World countries have achieved in publicly issuing securities in U.S. capital markets. Only a few privileged borrowers have been successful in selling these obligations and, even among these, very few have been able to penetrate the publicly traded international bond market. This source of private sector capital truly represents the final step in the evolutionary process of developing independent access to financial markets. With the possible exceptions of Mexico, Brazil, or Venezuela, there appears to be no other LAC country with the financial strength needed for a public offering.

This evaluation of an unguaranteed security must therefore focus upon the private placement market. During the course of this decade, there have been a number of LAC countries that have successfully placed their long-term obligations with some of the large institutional investors in this country, but these have tended to be the wealthier, the more industrialized, and the upper-middle-income countries in the region.

This experience suggests a fact that was well borne out during the course of the interviews we conducted for this study. Without any form of additional guarantee, it would be very difficult for an LAC country security to gain access to the portfolios of institutions that make up the private placement market in this country. As a result, the subsequent evaluation will focus upon the limitations and the additional security incentives needed to develop eventual access to this market.

The Unguaranteed Loan

As discussed in Chapter II, AID's development of a program that would provide access to private sector funds would be defined basically in terms of a co-financing arrangement. Such an arrangement could adopt any of a number of characteristics or conditions. Later in this chapter, we have identified some of the more viable of these. However, in its basic form, co-financing could be similar to existing programs currently being undertaken in conjunction with either the World Bank or the Inter-American Development Bank.

The World Bank's program has resulted in the availability of nearly $1 billion in co-financed loans since 1973, but these have been designed principally to attract private sector capital to self-supporting projects in the more developed of the developing countries, and to projects that are somewhat capital intensive and related to infrastructure or energy development. The role that the World Bank plays in these loans can vary, but usually includes providing prospective lenders with information about both the project and the borrower, the performance of any of a wide range of administrative and disbursement functions, and its agreement to a "cross-default" clause that would allow the Bank to declare its own loan in default if the borrower becomes delinquent on the portion of the loan provided by the private sector lender.

The World Bank's co-financing arrangements have given participating commercial banks the opportunity to conduct direct negotiations with a borrowing country or its designated agency. From some lenders' perspectives, this characteristic makes the program more attractive than the Complementary Financing Program that is administered by the Inter-American Development Bank. The terms of this program allow the Development Bank to make complete arrangements for the financing of a directly supportive and productive project in a particular country. Once these terms have been agreed to, this Bank encourages private sector lenders to bid for some portion of the total loan. This basically takes the form of a loan participation that is sold by the Bank on a nonrecourse basis.

An agreement that a commercial lender or other investor might enter into with AID and a borrowing country could take the form of either a "joint" financing or a "parallel" financing arrangement. The Complementary Financing Program is entirely joint financing, which implies that each lender (the commercial bank and the Development Bank) has a prorated common interest in all aspects of a particular project. More often than not, the World Bank program takes the form of parallel financing, in which each lender might negotiate to finance different components of a single large project.

A parallel financing arrangement seems to be better designed for AID's purposes because, in some cases, the type of program or project that AID may wish to finance might be fundamentally unacceptable to some commercial lenders. However, there might be particular aspects of that program or project that would interest a lender. By seeking his cooperation in financing only those acceptable aspects, a successful co-financing might be arranged. Parallel financing would also allow AID to develop the interest of some commercial lenders in providing the trade financing that might result from a particular program and, under certain conditions, the ability of a commercial bank to work with the Export-Import Bank or the Foreign Credit Insurance Association (FCIA) might support a parallel financing arrangement.

MARKET INTEREST

Much of our evaluation of the receptivity of the domestic financial markets will be presented in the form of summaries and interpretations of our interviews with a wide range of commercial banks, life insurance companies, and professional fund managers. The marketability of an unguaranteed LAC country security will be evaluated first, followed by a more thorough analysis of the unguaranteed loan.

Interest in an Unguaranteed Security

The private placement market is dominated by the country's largest life insurance companies. This financial arena is much less restrictive than the market for publicly issued securities. At the same time, however, it is limited by the statutes governing investment practices that were detailed earlier in Chapter II.

In the absence of an authorized guarantee program, the private placement market offers a potential for definite but limited access. However, it is also one of the more expensive sources of investment funds. Private placement yields in today's market are generally higher than those required in the publicly issued securities market, falling within the 10.5 to 12 percent range for fixed-rate financing. The perceived quality of many foreign government securities would probably force their cost to the upper end of this range.

Although access to the private placement market traditionally requires a premium over yields on comparable publicly issued securities, this marketplace allows a borrower to avoid many of the additional issuance costs that would otherwise accompany access to the publicly issued international bond market. For instance, private placements are exempt from the registration provisions required of public offerings by the Securities Act of 1933; illiquidity poses no problem because there is no defined need for an active secondary market, and the private placement investor has no difficulty in purchasing unrated securities or obligations.

While statutory considerations interact to make this a financial market that offers only limited opportunity for foreign investors, the place for international diversification among these private placement portfolios is traditionally reserved for the governments of industrialized countries and the strongest private sector borrowers within those countries. Interviews with private placement portfolio managers indicated significant reluctance to consider any but the four or five LAC countries that have demonstrated the greatest political stability and economic progress, and some went so far as to say that even a country with the financial resources of Mexico would be denied access to private placement funds. This attitude was expressed throughout the interviews and appeared to be based upon three basic investment review considerations:

- These institutions find it unnecessary to provide development financing when they are content with the yields available elsewhere from more industrialized international borrowers.

- The political risk perceived in some of the South American countries and more prevalently throughout the Middle American and Caribbean countries does not justify direct investment at this time.

- These institutions as a group limit their investment in international securities to the 1 percent restriction imposed by the State of New York (see discussion in Chapter II) and some which did not approach this limit expressed a preference to invest their resources in areas directly benefiting their policyholders.

Comments such as these do not categorically exclude the life insurance companies from participating in a financing arrangement with AID under some limited conditions. They do suggest that those conditions must be significantly more restrictive than the Agency may desire. The ability to work directly with AID to evaluate a project or a country is considered a very attractive feature, but in no case is it found to be sufficient to attract a private placement institution to invest in a country that it would not otherwise invest in. AID's participation in a project might only serve to allow an otherwise acceptable borrower to negotiate a somewhat lower cost of private sector funds.

Interest in an Unguaranteed Loan

We found some commercial banking interest in working on a co-financing arrangement with AID. However, in nearly every instance, acceptable terms of the agreement were very conservatively defined. In many cases, AID would have to reassess its objectives in order to agree to them. However, it is important to keep in mind that AID does offer a number of unique advantages to some lenders, some of whom would recognize these advantages as offering different degrees of benefit. These might include:

- the availability of AID's technical and administrative staff which could significantly simplify the process of evaluation that a lender would have to complete to properly assess the viability of a project;

- the presence of AID's own existing relationships both with the government of the borrowing country, and with the country's central bank;

- the opportunity for a commercial bank to initiate new relationships with the central bank and with new and developing businesses and industries within borrowing countries;

- the opportunity to combine the lender's own commercial loans with AID's highly concessionary funds that would offer added security to the economic viability of a particular project; and

- the favorable public image that could develop out of being one of the first banks to provide economic assistance along with AID to Third-World countries.

There are a number of commercial lending objectives which a proposed co-financing arrangement must be able to fulfill to make such a program attractive. These objectives are interrelated and, in some cases, one may be compromised so that another may be more broadly fulfilled. They can be broken down into three groups: (a) market terms, (b) acceptable risk, and (c) business development opportunity. Each bears a particular relationship to developing an acceptable co-financing relationship with AID.

Market Terms

The market among international commercial banks for extending loans to the governments of developing countries is currently a highly competitive one. Despite this, almost no commercial bank to which we spoke was interested in fixed rate financing for LAC countries. The few domestic commercial lenders that would agree to an intermediate-term (as much as 5 or 7 years), fixed-rate loan, set other conditions that precluded an AID-related project from eligibility. Current lending conditions in nearly all cases call for a "floating" rate at some premium over either LIBOR or the U.S. prime rate.

While this rate was described to be negotiable only within a relatively narrow range, the term or maturity agreed upon by a commercial lender can demonstrate much greater variability. Most lenders agreed that a 7- to 8-year term was typical in today's market, but there are some projects that could justify a repayment period of up to 10 or 12 years. The term is most often determined by the repayment capability inherent in a particular project. When a loan is made to the government of a Third World country or to its agency, an acceptable maturity would be determined by the country's financial capacity and by its current outstanding credit obligations.

Acceptable Risk

Lenders use a number of criteria to evaluate the creditworthiness of a particular borrower and the merit of financing a particular project. These include such economic variables as monetary reserves, external debt ratio, domestic rate of inflation, the relationship of the country's exports and imports and its balance of payments, and other expressions of fiscal responsibility. In evaluating a project, other criteria such as employment generating capacity, ability to reduce imports or generate foreign exchange, and the country's financial commitment to that project are all relevant. Overshadowing all of these characteristics, the perception of political risk within the country becomes very important.

It is interesting that these criteria can be and are interpreted differently by different commercial lenders. As a result, the responses provided in the course of the field interviews varied significantly with respect to the acceptability of particular projects and countries. Some lenders indicated that only the most commercially viable of AID's projects would be acceptable, under some conditions, for a co-financing arrangement. Others stated that even those AID projects that are entirely of an educational or training nature and that entail no capital or infrastructure development, are compatible with the type of public sector lending that they currently do.

Many defined acceptable risk as allowing public sector lending to LAC countries only for projects that were considerably self-supporting, that generated foreign exchange, that resulted in a reduction in imports, or were in some other way tied integrally into the economy of the borrowing country. However, there was also a large group of commercial banks which felt that the purpose to which borrowed funds were put was not always relevant; instead, it was only the creditworthiness of the borrowing country and its existing credit relationship with that bank and others that was important.

Business Development Opportunity

Throughout the interviews, the potential for developing new commercial lending business was mentioned as one of the motivating forced encouraging commercial lenders' interest in an AID co-financing arrangement. This is particularly the case for some of the LAC countries in which AID projects interface with emerging industries or the development of energy sources. A borrowing country may therefore be able to use its alternative needs for commercial credit and opportunities to work with its central bank as incentives to attract a U.S. commercial bank to participate with AID in financing some of the assistance and development projects that would not otherwise be considered commercially attractive.

IMPACT UPON AID'S OBJECTIVES

The results of our interviews demonstrate cetegorically that no lender or investor was interested in an unguaranteed financial instrument that would fulfill all of AID's stated objectives. In this section, the necessary degree of compromise in both the financial and the programmatic objectives will be assessed.

The alternative of private placement of an LAC country's unguaranteed security would have no difficulty accommodating AID's requirement of at least 1:1 leverage. The investment objectives of most private placement portfolios are compatible with the need for a flexible grace period and extended maturities of up to and sometimes beyond 15 years. In theory at least, this market allows for continuous access on a recurrent basis and can readily provide investment capital in the small amounts of $5 to $10 million that is consistent with AID's expected project requirements. However, it would be extremely difficult to secure access to this securities market for any but the strongest countries within the LAC area, and AID is less interested in designing an instrument that could be used only for these countries.

It is more important to address the impact or limitations that a conventional co-financing arrangement would have upon AID's financial objectives. In current credit markets, the domestic prime rate is at 11.5 percent and LIBOR at about 10.75 percent. A premium over these floating rates could be conservatively estimated to bring the cost of borrowed funds to some LAC countries to 13 percent. Some other countries in this region could certainly negotiate a more attractive commercial rate, but we will use it here to estimate an illustrative "high cost" set of conditions. Of course, should interest rates tighten further, such an estimate will become less conservative, but it is inadvisable for AID to initiate a new co-financing program in a period of unusually high interest rates.

With a 13 percent expected cost of commercial funds, AID would be able to secure a 1:1 leverage ratio, but no more.[1] There are, however, other factors which might limit a lender's interest in participating in a 50/50 relationship with AID. Among these are the type of project to be funded, the particular maturity that the lender has agreed to fund for, or possibly the country's long-term political stability. As a result, requiring a dollar for dollar commitment from a private sector lender may initially be too demanding. The alternative of requiring that a smaller portion of funds be loaned by a commercial lender offers the benefits of lowering the combined cost of such funds to the recipient country, and bringing the amount committed to a project by a host government into closer proportion with that of the commercial lender.

Such a situation is portrayed in Exhibit V-1 to demonstrate that, as the leverage requirement is reduced, so is the total blended cost of funds to the borrower. The commercial lender may insist on a greater contribution

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[1]To achieve an 8 percent blended cost of funds, AID would be required to put up $1.00 of its own concessionary funds for each $1.00 of conventional money:

$$(0.50 \times 3.0\%) + (0.50 \times 13.0\%) = 8.0\%$$

EXHIBIT V-1

IMPACT OF A CHANGE IN LEVERAGE ON THE BLENDED COST OF FUNDS AND ON THE CO LENDER'S COVERAGE OF A BORROWER'S CONTRIBUTION

LEVERAGE	SOURCE OF FUNDS	CONTRIBUTION	COST TO BORROWER	COVERAGE
1:1	Recipient Country	25.0%		
	AID	37.5%	3.00%	
	Private Sector Source	37.5%	13.00%	
		100.0%	8.00%	150%
2:1	Recipient Country	25.0%		
	AID	50.0%	3.00%	
	Private Sector Source	25.0%	13.00%	
		100.0%	6.33%	100%
3:1	Recipient Country	25.0%		
	AID	56.2%	3.00%	
	Private Sector Source	18.8%	13.00%	
		100.0%	5.50%	75%

from the borrowing country vis-a-vis the amount of the loan. In this exhibit, the coverage is defined as the proportion of the borrowing country's contribution to a particular project that is provided by the commercial lender.

Earlier, it was pointed out that AID requires that at least 25 percent of the project's total cost come from the recipient country. As a result, with a leverage factor of 1:1, both AID and the commercial lender are lending one-half of the remaining 75 percent of the project's cost, or 37.5 percent each. That is, a 1:1 leveraging of AID's resources requires that a commercial lender provide 150 percent as much to a project as does the borrowing country.

As the leverage factor decreases, so does the lender's coverage. This not only provides greater security to the commercial lender, but it also reduces the blended cost of funds to the borrowing country. For instance, that average cost of 8 percent, under the conditions of a 1:1 leverage, could be reduced to 6.33 percent when the commercial leverage is reduced to 2:1, and to a cost of 5.5 percent when that leverage is reduced to 3:1.

Such additional funds would be expensive, and it is unlikely that they could be made available for a period much longer than the intermediate term of 6 to 8 years. This indicates that an unguaranteed co-financing arrangement would provide only adequate fulfillment of both the leverage and concessionality levels levels that AID wishes to achieve. However, the last financial objective, the establishment of a continuous market, would under most conditions be easier to fulfill. Once AID has developed a co-financing program such as this, commercial banks will probably become more accustomed to making such loans. While this would encourage a continuous potential source of funds, it is one that can be volatile; during periods of credit stringency, the ability of the commercial banks to provide funding for marginal projects would diminish.

Although the financial objectives can be preserved to an adequate degree under the likely terms of a co-financing arrangement, they are fulfilled only to a point that is contingent upon the type of project and, more importantly, the particular borrowing country. Our field interviews provided very strong evidence that there are some LAC countries in which no lender would be interested, even under the conditions of a favorable co-financing arrangement with a short maturity and a high return. As a result, any unguaranteed instrument would fail to fulfill AID's objective of providing funds to all of the middle-income LAC countries, but there was definite enthusiasm for involvement in co-financing with AID in some of these countries.

Even among those lenders who indicated selective interest in some LAC countries, there was still a certain amount of reservation about the type of project that would be financed. While some lenders expressed the opinion that public sector lending to Third-World countries was predominantly determined by country evaluation and not by a close assessment of the use of the funds, there is an even larger group that felt borrowed funds could only be made available for a project that was very close to being commercially viable and self-supporting.

SELECTION AND IMPLEMENTATION

The two alternatives of unguaranteed obligations that are considered in this chapter are the only techniques for securing private sector capital that AID can pursue without additional enabling legislation. The unguaranteed security is an inadequate alternative because it seriously limits eligible countries. As a result, the unguaranteed loan, in the form of a co-financing arrangement, is the most viable course of action currently available to AID.

The program of unguaranteed co-financing shows promise of generating some initial market interest. It fulfills most of AID's stated objectives and, because it can be implemented under AID's current authority, the PMM&Co. project staff suggests that AID begin its development of a private sector financing program with this approach. This will permit AID to develop immediate relationships with the U.S. commercial banking community, and it will lay the framework for the development of a guaranteed or a partially guaranteed program should such authority at some time be granted.

To put a co-financing program into effect, AID may wish to develop a detailed implementation plan which includes a statement of program objectives and policies, a detailed instrument design and marketing plan (including a draft co-financing contract), projected program levels, projected costs associated with expected program levels, and a description of the tasks that must be performed for successful start-up. As preliminary input to such an implementation plan, this section describes the characteristics of an unguaranteed co-financing program and presents our findings about each characteristic's implications for the success of the new instrument.

Borrower's Involvement

Our interviews with the financial community in general, and with commercial bankers in particular, indicated that increased involvement by a borrowing country can contribute significantly to the level of interest and to the support offered by lenders. At a minimum, this requires that the borrowing country provide its own 100 percent guarantee, a requirement common to all AID projects.

A second AID requirement dictates that the host country must provide 25 percent of project costs in funds or in kind. In the last section, it was demonstrated that commercial lenders are attracted to projects in which their own coverage (that is, the ratio of their loan to the amount paid directly by the borrowing country) is relatively small (i.e., possibly less than 100 percent). AID could therefore attempt to arrange co-financing for those projects that have received the greatest degree of financial commitment from the recipient country.

Finally, the borrowing country should be encouraged to include some assurances in its agreement with the lender that the project will be completed. Such an assurance might take the form of a contingent reserve fund provided for by the borrower that is established for just such a purpose. This is particularly important for construction projects in which an unfinished structure would provide vivid testimony of any project failure. Many lenders, particulary commercial banks with operations in the recipient country, would not like to be associated with incomplete projects--even if their loans loans were repaid fully and on time.

Target Lenders

Lender participants in an unguaranteed co-financing program may be individual institutions, small groups of institutions, or larger investment syndicates. The types of institutions that might participate include large international commercial banks, which may or may not have offices in the borrowing country, large regional banks which lack such facilities, and large insurance companies. Other types of investors (such as pension funds, mutual funds, and smaller banks) are generally either not interested in foreign lending, or reluctant to make unguaranteed loans to developing countries.

To initiate the program, participants should be sought from among the top ten (by asset size) commercial banks, nearly all of which hold a broad, internationally diversified loan portfolio, or any of the top 25 or 30 regional banks. Members of both of these groups will be eligible for lending under the conditions of the proposed co-financing arrangement, but each group has demonstrated somewhat different characteristics.

The large U.S. commercial banks that are internationally oriented have all indicated during our interviews that they already hold a large portfolio of obligations from many LAC countries. They therefore have an existing lending relationship with the governments of many of these countries as well as with their indigenous industries. These banks are familiar with the LAC countries, have a staff that is experienced in evaluating them, and have a sufficiently large portfolio that can absorb the added risk of additional unguaranteed loans.

The smaller regional banks, however, enjoy the benefit of neither broad experience in this group of countries, nor the staff necessary for adequate evaluations. AID could attract the interest of some of these banks by helping them to develop additional business opportunities and by providing the technical and administrative capability that they themselves might not be able to maintain.

As the program develops, some insurance companies might be brought in as participants in bank co-financing arrangements. This approach has considerable appeal among a number of insurance companies. The presence of a commercial bank as a co-lender may, in some instances, be regarded as an indicator of acceptable risk. In addition, the participation of an investment banker in negotiating the co-lending agreement is seen by some insurance companies as a very favorable approach, as the investment bankers are familiar with the insurance companies' investment requirements.

Bankers interviewed have also indicated a willingness to participate in a co-financing arrangement with insurance companies. The banks, of course, would be more interested in the shorter maturities (10 or 12 years, at most, and more likely 5 to 7 years while the program is new), while the insurance companies are able to provide fixed-rate financing on a long-term basis, with a maturity of up to 15 or 20 years.

Selection of Project and Country

The selection of the first project and country to participate in a co-financing arrangement will play an important role in determining the overall success of the entire program. Only a project that has the clear and unambiguous support of the borrowing government should be considered. It should be both economically productive and, at least to some extent, revenue generating. In total, that first project should approach as closely as possible those conditions necessary for a commercially viable project.

Ideally, the first project should allow for a number of commercially attractive characteristics. First, it should allow for parallel financing, so that a particular portion of it can be separated from the remainder of the AID project and financed under entirely commercial terms. Second, the project would be attractive if it results in the need for trade credits, by requiring that particular elements of the project be imported from the U.S. Third, some portions of the selected project should be suitable for financing on a short- to intermediate-term basis. There will be significantly more market interest in a co-financing arrangement that allows the commercial lender to be entirely repaid in, for instance, 3 to 5 years, than in one that requires at least a 6- to 8-year commitment. Once a program has been established, a longer term financial commitment can be developed.

Finally, it is important to reemphasize the point made in Chapter III that projects should be selected with the intention of keeping the nominal amount of the loan as large as possible. This is particularly important when attempting to attract commercial lenders to a country with which they do not have a current credit relationship. It is time-consuming and expensive to evaluate a project in an unfamiliar country. Although AID is in a position to make much necessary information available, there remains the added difficulty of establishing a working relationship with AID. As a result, from the perspective of a potential co-lender, the commitment of time necessary for such an evaluation can only be justified by a sizable loan amount.

The initial project should be evaluated according to its suitability for serving as a pilot program. It should be an example of AID's best administrative and technical capability because, in an initial program, potential lenders will evaluate AID as closely as they will the country and program to be financed. However, this will also mean that the type of project selected for a pilot program should be within an industry group that might attract the broadest market appeal. Examples here could include nearly anything related to energy, mineral extraction, or particular programs essential to the development of new industries.

Finally, the borrowing government that sponsors the pilot program must be most carefully selected from a relatively narrow group of countries that are economically and politically stable, and that have demonstrated overall good management, some fiscal responsibility, and a general level of creditworthiness. Throughout the course of our interviews, this was cited as being the most important variable in the success of the proposed program.

Borrower/Private Lender Relationship

A new program of unguaranteed co-financing can probably achieve the desired level of market interest only if it allows for direct negotiation between the borrowing country and the private sector lender. Many lenders will require such direct contact with the borrower as a prerequisite for their participation. For this reason, such lenders have been willing to participate in the World Bank co-financing program but not in the Complementary Financing Program of the Inter-American Development Bank.

AID Participation

In the course of this study, PMM&Co. reviewed a variety of ways that AID might structure an unguaranteed instrument to make it more attractive to potential lenders and investors. It was felt that the borrowing country should be encouraged to come to agreeable terms with a source providing money at fully conventional rates. To accomplish this, we suggest that AID make the availability of its own concessionary resources contingent upon the borrower's acceptance of the private sector participation at market terms. This approach would have the effect of creating a new co-financing instrument for the provision of assistance to middle income countries at rates higher than AID's normal concessionary rates but lower than market rates.

While the U.S. commercial banking industry is the most likely source of funds for this program, the funds are generally unavailable for more than a 6- to 8-year period. For this reason, AID could obtain the most attractive terms for a borrowing country if it allows the commercial bank participating in co-financing to assume only the early maturities of the entire lending agreement. The commercial loan could be repaid during the period (a grace period) when AID requires only the repayment of interest at its concessionary rate. At the maturity of the commercial loan, the borrower could begin repaying principal to AID.

During the field interviews, inclusion of a subordination or a cross-default clause in a co-financing agreement was discussed to determine the extent of interest shown by commercial lenders. Few of the institutions that were interviewed expressed even moderate interest in a feature that would subordinate AID's claim to periodic repayment to that of the commercial lender. Although some large insurance companies showed limited interest in this idea, commercial banks generally felt that it offered only marginal additional security; they preferred to see each participant in a co-financing arrangement have an equal interest in a project. In some cases, it was mentioned that such a feature might offer some advantage to the commercial lender should a restructuring of the entire loan become necessary, but we would not conclude that that the inclusion of such a feature is necessary in defining a co-financing arrangement.

Potential co-lenders reacted quite favorably to the idea of a cross-default clause, and some indicated that the broader the coverage available under such a clause, the more attractive such terms would be. Under the most favorable possible terms, default on a payment would warrant calling not only the other lender's loan, but also possibly calling all loans extended to the defaulted borrower by both co-lenders. Such comprehensive terms, however, are rarely attractive to a borrowing country, but a more moderate version was considered to be important to most of the lenders interviewed.

Several representatives of banks and life insurance companies also expressed a strong preference for a cross-default clause that requires automatic rather than optional calling of the second loan in the event that a co-lender's loan was defaulted upon. One insurance company even went so far as to say that it could not consider participating in an unguaranteed co-lending program if a mandatory default clause were not included in the agreement. Others indicated that this had been a problem with the World Bank's co-financing program that had discouraged interest in it by a number of U.S. banks.

It was also suggested that AID might provide the private sector lender with assurance that any well-defined project overruns would be funded through subsequent AID appropriations. At present, AID receives its appropriations on an annual basis from Congress (except for certain limited programs not relevant to this discussion). Because the appropriations are on an annual basis and are subject to action by Congress, AID could not commit, as a practical matter, to finance project overruns through subsequent AID appropriations. Nevertheless, in approving a project or program for financial assistance, AID could allocate a portion of a current appropriation as a contingency fund for the particular project to supplement the payment of any project overruns by the borrowing country. Failure to provide these funds as needed would constitute default.

The advantages made available by AID's administrative role in co-financed projects were broadly recognized by the lenders that were interviewed. However, many expressed the opinion that AID's record in development lending is not widely known in the financial community. Although AID's insistence upon retaining final approval of all disbursements is considered a complication of the private lender's relationship with the borrower, it represented a condition that most lenders would probably accept with some reluctance.

Finally, the opinion was occasionally expressed that AID project a positive image of its administrative capability by demonstrating that participating in a co-financing relationship with AID would substantially simplify the international lending process, rather than complicate it. This is particularly important if AID is to attract the interest of those commercial banks that do not maintain their own staffs throughout the LAC area. Therefore, PMM&Co. suggests that a co-financing program, if enacted, be designed to be flexible and relatively simple, and allow maximum autonomy to the commercial lender.

VI. SUMMARY AND CONCLUSIONS

The preceding three chapters have provided evaluations of possible alternatives that were grouped by the degree of guarantee that would be provided by the U.S. Government. At the end of each chapter, an instrument in the form of a loan made directly to a borrowing country was selected as the most attractive method in that group for providing private capital to a broad group of LAC countries.

Exhibit VI-1 summarizes our assessment of these three selected instruments and evaluates the three types of loans on the basis of the same criteria used in the earlier chapters. As the exhibit shows, the fully guaranteed loan alternative offers AID a number of advantages over its unguaranteed and partially guaranteed counterparts. A guaranteed loan can reach a broader market; it can provide for a much greater leverage of AID resources; it can provide for the most concessionary set of terms; it can be used on a recurring basis with relative ease; it can utilize AID's administrative capabilities in project financing; and finally, it can provide funding for a full range of projects in virtually all of the LAC countries. The exhibit further indicates that all but the fully guaranteed loan would be significantly more restrictive and would provide AID with a much less flexible mechanism for providing capital resources in areas where the Agency considers them most purposeful.

To achieve the benefits that this alternative would allow, AID must pursue the legislation necessary to obtain guarantee authority. However, in seeking this authority, AID should recognize that it has two viable marketing alternatives from which to choose. On one hand, AID can consider funding its projects through the sale of a borrower's guaranteed obligations to the FFB. On the other hand, the loans could be publicly underwritten in a manner similar to that used for HG loans and, in fact, the existence of this program should facilitate the administrative implementation of a new guarantee program.

However, the passage of the legislation necessary to allow AID full guarantee authority cannot be assured, and the legislative and administrative processes required for approval and eventual implementation would likely be lengthy and time-consuming. As an alternative, AID can consider the other available instruments, recognizing that they would be less suitable to fulfilling all of AID's stated objectives. There would be substantially less resistance from the Executive Branch to a partially guaranteed loan program, but its implementation would similarly require extensive legislative and administrative action. Instead, the development of an unguaranteed co-financing program is an alternative that is entirely within AID's statutory authority. AID might develop a pilot program that is consistent with the implementation plan presented at the end of Chapter V.

EXHIBIT VI-1

SUMMARY: EVALUATION OF THREE SELECTED INSTRUMENTS

EVALUATION CRITERION		INSTRUMENT	FULLY GUARANTEED LOAN	PARTIALLY (80%) GUARANTEED LOAN	UNGUARANTEED LOAN
MARKET INTEREST			BROAD INTEREST	LESS BROAD INTEREST	NARROW INTEREST
AID ADMINISTRATIVE OBJECTIVES	FINANCIAL	Approximate leverage expected under current market conditions	Very high leverage; possibly 1:3 depending upon reserve requirements	1:2 to 4:3 depending on reserve requirements; 3:4 if a 25% reserve is established	1:1 and possibly less
		Concessionary terms	Fixed-rate, long-term; cost estimated at about 9.75 percent and less if sold through the FFB; would allow for attractive concessional terms	Fixed-rate, intermediate to long-term; cost estimated at about 10.6 percent; in conjunction with AID, would allow an adequate level of concessionality	Floating rate; probable maturity of up to 6 to 8 years cost estimated at about 12.5 to 13 percent; co-financing with AID would allow some concessionality
		Market establishment	Recurring use with relative ease	Available through recurring negotiation	Available through recurring negotiation
	PROGRAMMATIC	Type of project	Virtually any type of project	Projects would be matched with lenders' interests	Projects would be matched with lenders' interests; might be limited to most self-supporting
		Borrowing countries	Nearly any borrowing country	Unguaranteed portion would result in a somewhat limited range of eligible borrowers	Would allow for a restrictive range of borrowers, but range may broaden depending upon particular interest of lenders
		AID Administrative Control	Virtually assured but subject to borrower approval	Acceptable, subject to negotiation	Acceptable, subject to negotiation
IMPLEMENTATION REQUIREMENTS		Legislative	New authority required	New authority required	Existing authority sufficient
		Administrative	Expansion of AID's HG program concept would facilitate implementation	New program; additional workload	New program; additional workload

Pursuing this alternative at this stage offers AID a number of advantages. First, and most important, it would initiate the exposure necessary between AID and the commercial banking industry in this country. Throughout the interview process, banking officers indicated a substantial lack of familiarity with AID and with the type of economic development activity AID participates in. An educational and marketing effort aimed at promoting AID's own image within the private sector capital markets is therefore an essential initial step.

The development of this relationship is also necessary to educate AID in the process of evaluating projects in terms of acceptable commercial risk. Commercial lenders will be very concerned about both the economic and political risk inherent in any unguaranteed loan, and must feel confident that AID is evaluating these variables in a way that is consistent with their own analysis. The benefits of this exposure could be applied to the evaluation of all AID projects, and would contribute to improving the overall professionalism within AID as it is perceived by the commercial banking industry.

Steps taken at this time to implement a pilot program will require that AID determine the specific terms that will be necessary to define an acceptable co-financing relationship. As pointed out in Chapter V, these terms may initially be relatively unattractive and may offer little in the way of concessions to a borrower. However, because it is important that a lender's experience with this pilot program be a favorable one, it is essential that AID be sensitive to his concerns and allow for the incorporation of even the most conservative of provisions into a pilot design. Not only can these terms become more favorable to AID and to the borrower as the program develops, but such terms and negotiations lay the groundwork for more easily developing a guarantee program at such time as approval is given.

Finally, the development of an unguaranteed co-financing program provides the immediate benefits of introducing some additional private sector funds to AID-sponsored projects, and it facilitates the development of a commercial relationship between the borrowing country and the U.S. commercial banking community. The fact that there is some genuine commercial banking interest in working with AID--restrictive though it may be--suggests that the framework for a sustained and more favorable program does exist. The extent to which AID is able to harness this interest can contribute to broadening the scope of AID's activities without further budgetary appropriations.

ATTACHMENT A

INTERVIEWS CONDUCTED WITH THE INVESTMENT COMMUNITY

LIFE INSURANCE COMPANIES

- AETNA Life Insurance Company
  Hartford, Connecticut

- American General Life Insurance Company
  Houston, Texas

- Connecticut General Life Insurance Company
  Hartford, Connecticut

- Equitable Life Assurance Society
  New York, New York

- John Hancock Mutual Life Insurance Company
  Boston, Massachusetts

- Metropolitan Life Insurance Company
  New York, New York

- New York Life Insurance Company
  New York, New York

- Northwestern Mutual Life Insurance Company
  Milwaukee, Wisconsin

- Prudential Insurance Company of America
  Newark, New Jersey

COMMERCIAL BANKS

- Bankers Trust Company
  New York, New York

- Bank of Boston - International
  New York, New York

ATTACHMENT A (Continued)

- Citibank
  New York, New York

- Chase Manhattan Bank
  New York, New York

- Chemical Bank of New York
  New York, New York

- Continental Illinois National Bank
  Chicago, Illinois

- First City Bank of Texas
  Houston, Texas

- First National Bank of Chicago
  Chicago, Illinois

- First National Bank of Dallas
  Dallas, Texas

- Flagship Bank
  Miami, Florida

- Manufacturers Hanover Trust Company
  New York, New York

- Morgan Trust Company
  New York, New York

- Pan American Bank
  Miami, Florida

- Republic National Bank of Dallas
  Dallas, Texas

- Southeast First National Bank of Miami
  Miami, Florida

- Texas Commerce Bank
  Houston, Texas

ATTACHMENT A (Continued)

INVESTMENT BANKERS AND INVESTMENT MANAGERS

- Bear, Stearns, & Co.
  New York, New York

- Morgan Stanley & Co.
  New York, New York

- Fayez Sarofim & Co.
  Houston, Texas

ATTACHMENT B

INTERVIEWS CONDUCTED WITHIN THE WASHINGTON, D.C., INTERNATIONAL FINANCIAL COMMUNITY

The Export-Import Bank

The Inter-American Development Bank

The Foreign Credit Insurance Association

The Overseas Private Investment Corporation

The World Bank

The Federal Financing Bank

The Office of Management and Budget

The U.S. Department of the Treasury