

# IFM BULLETIN

Sustainable Development Department of the Inter-American Development Bank

## The Use of Guarantees: the Perspective of Borrowing Governments

By *Pietro Masci*  
Division Chief, SDS/IFM

### Introduction

Governments in emerging and industrialized countries frequently use guarantee operations with limited transparency and disclosure. Governments provide guarantees when, for example, the viability of a public enterprise is threatened by unforeseen events and it does not have the creditworthiness to obtain loans or raise funds on the market. Another example would be a guarantee for a private lender that is not willing to bear certain risks associated with infrastructure projects.

There are various types of guarantees: those related to disasters, claims for judicial awards, lawsuits, social safety-net provision or loans (e.g., loan, performance and completion guarantees). The guarantees supplied by governments create contingent liabilities. Given that guarantees are often provided outside the normal budgetary process, the liability is not recognized until it becomes due, and the real cost of the guarantee is not calculated or disclosed.

To better represent exposure, government accounting systems should be designed to explicitly recognize contingent liabilities as part of the normal budget exercise. This disclosure of guarantees and their costs is important to:

- correctly assess the level of the government budget and the impact on the deficit
- properly allow the Legislative branch to compare expenditures (e.g., measure the cost of a Guarantee Loan Program vis-a-vis the cost of other expenditures and make educated decisions about the allocation of the resources of the budget).

This article provides a brief review of the practices of governments in the area of guarantees; illustrates the method applied

in the US to evaluate the cost for the government of loans and loan guarantees; emphasizes the importance of correct valuation and disclosure of the cost of guarantees; and focuses on the programs of Multilateral Development Banks (MDBs) to provide partial risk and partial credit guarantee for infrastructure projects with the government counter-guarantee.

### The Disclosure of Government Allocation of Capital

The allocation of capital involves efforts by the government to direct the flow of

savings toward desirable projects and/or to lower the interest cost for these projects. The instruments used by governments for allocating capital include:

- (1) ceiling or usury rates of interest on loans
- (2) interest-rate subsidies
- (3) government borrowing in the financial markets and re-lending to socially desirable projects
- (4) the use of regulations to divert the flow of savings toward socially desirable projects
- (5) tax-exempt financing

(continued on page 4)

## Social Security Reform in Small Emerging Economies

By *Kenroy Dowers*,  
Financial Sector Specialist, SDS/IFM  
*Stefano Fassina*,  
Senior Researcher, Economics Department,  
Office of the Prime Minister of Italy

### Background

In recent years, many countries have focused on devising solutions to the old age crisis, which has been linked to changing demographics and the inability of existing social security systems to meet promised benefit levels. Some manifestations of this old age crisis include:

- increased deficits crowding out investment in education health, and infrastructure
- insufficient provisions for old age benefits that are not indexed
- perverse redistribution from the younger to older generations and low to medium-high income workers
- hindered growth as the systems mature and become a burden for gov-

ernment revenues

- high wage taxes that encourage evasion and informality
- reduced incentives for saving
- incentives for early exit from the labor market

Countries have responded differently to this impending crisis depending on their circumstance. For example, in Africa and most of Asia, the elderly are a significant part of the population and informal structures have generally been in place to deal with old age income insecurity. With the goal of reducing liberal early retirement provisions and generous benefits, several Latin America have coun-

(continued on page 2)

### Contents

Social Security Reform in Small Emerging Economies	2
The Use of Guarantees: the Perspective of Borrowing Governments	4
Editor's Desk	10

## Social security reform

(from page 1)

tries have introduced fully-funded, defined-contribution programs that give contributors a choice among different privately managed funds. Countries that belong to the Organization for Economic Cooperation and Development (OECD) appear to be moving toward a system that combines a publicly managed pension program with fully-funded privately managed occupational pensions or saving plans that target the needs of higher income groups.

Notwithstanding variation in the types of structures, most of the recent models for social security reform display elements of a multi-pillar structure, which combines a first layer of welfare benefits financed with public revenues, a second mandatory PAYGO or fully-funded layer, and an optional third layer made up of privately managed individual accounts. While the major reform alternatives in developing countries display these characteristics, new attention is being directed at the applicability of these models to solve the old age crisis in small emerging economies. This article focuses on the applicability of the some of the recent reform approaches for solving the social security problems for small emerging economies.

### Alternatives for Social Security Reform

Recent approaches to social security reform could be grouped into two camps, according to the impact on the system. The first is parametric reform and the second is comprehensive reform. Parametric reform involves changes in an underlying feature of the current system, including the pension formula, retirement age, benefit indexation mechanism, regulatory structure or collection period, and privatized fund management. Parametric reform leaves the basic social security system intact and focuses on reducing the fiscal deficits based on the implied debt of the pension system or eliminating inter and intra-generational inequities. This approach only temporarily postpones the fiscal crisis engendered by existing social security arrangements, or it achieves financial sustainability but fails to completely realize the overarching goal of reducing old age income insecurity.

Comprehensive reform involves significant structural modification of the retirement system. Typical characteristics of comprehensive reform include:

- Multi-pillar structure with a mandatory public first pillar, mandatory PAYGO (pay-as-you-go) or fully-funded second layer, and a voluntary third layer
- Private management of the pension assets
- Benefits linked to contributions through defined benefit schemes (notional or actual)
- Individualized accounts
- Tax breaks for savings dedicated to pension system
- Enhanced legal and regulatory framework

### Characteristics of Small Economies that Impact on Reform Process

While the reforms specified above strive to realize specific efficiency and equity objectives, there are factors that are particular to small emerging economies that limit their efficacy. These factors pertain

to demography, the structure of the economy, the labor market, financial market development, and political economy.

In terms of demographic conditions and structure of the economy, small economies have limited possibilities for efficiency gain based on economies of scale. With respect to the economic structure, many small emerging economies have low savings rates, high inequality in income distribution, and a high corporate tax rate, all discourage participation in additional savings mechanisms. For example, in many instances the national income is derived from a one major activity that is based on traditional agricultural or extractive industries that suffer from the vagaries of external economic pressures. Also, many of the macro-economic fundamentals such as fiscal deficit, interest rate, inflation, exchange rate, and balance of payments are often not well managed.

With regards to the financial sector, a critical assumption of the multi-pillar structure is the existence of financial markets that permit reasonable returns on investments of portfolio assets. In many small emerging economies, if there is a functioning financial market at all, it is usually embryonic, offering few investment opportunities and lacking an adequate legal and regulatory framework. These conditions tend to be combined with capital account constraints that limit the possibility of securing larger returns and portfolio diversification from investment in securities traded in foreign markets. These two factors severely limit the potential benefits of a privately managed mandatory program.

The political economy of many small emerging economies also impacts the structure, commitment to and implementation of reforms. Bad habits formed by a history of distortion and political involvement in the management and provision social security benefits are difficult to relinquish. Also, the use of social security funds to finance the government and state enterprises, coupled with low regulatory capacity, produce inertia when it comes



The Inter-American Development Bank

### IFM BULLETIN

#### Editorial Board

A. Aguila, E. Machado, T. Powers, P. Masci

#### Editor for this issue

Kenroy A. Dowers

1300 New York Ave., N.W.

Washington, D.C. 20057

Stop W-0508

Phone: 202-623-1608

Fax: 202-623-2157

Internet: IFMMAIL@IADB.ORG

The Infrastructure and Financial Markets Division of the IDB provides technical and advisory support, research and dissemination within the IDB group. The Bulletin is an internal document for Staff that aims to provide a source of information on relevant topics in infrastructure, finance and related areas.

---

## Social security reform

time to implement reform. Though many social security funds in small economies have acquired surpluses, a large contingent liability exists for the unfunded civil service element. Reform requires the government to recognize this liability in a transition to a funded system, and this has also proven to be a disincentive for implementing reform.

### Social Security Reform for Small Economies

The picture painted in the previous sections suggests that the current proposals for reform are not wholly applicable to small emerging economies and would require modifications to be more relevant. Modifications could focus on the approach to investment management, the regulatory framework, and regionalization.

#### *Investment Management*

Many countries in Latin America and the Caribbean that have implemented the multi-pillar approach establish Pension Fund Administrators (AFP) that compete for the management of contributions from employees. In small countries, however, limited domestic investment opportunities curtail the efficiency gains derived from portfolio performance. Alternatively, there are greater potential efficiency gains when there is (i) centralized collection of pension assets, perhaps tied to another collection system such as the tax system; (ii) financial management of the assets; and (iii) bargaining for annuities from insurance companies.

The centralization of collection and investment management does not preclude having multiple private portfolio managers. For example, money managers (both local and international) could be invited to submit bids to manage pension assets. In this case the portfolio manager would not maintain an infrastructure for collecting funds from pension contributors. In addition, there would be no need to develop marketing strategies to attract pension contributors to support a particular AFP. Under the proposed system, the portfolio manager would bid for a long-term concession (not less than 5

years) to manage either some or all pension assets. Bolivia and Sweden have utilized this structure and they are good examples of limited competition bidding with efficiency gains due to centralized collection systems.

One cannot address investment strategy issues without considering which modern portfolio management techniques are appropriate for small economies with constrained capital and limited investment opportunities. As established in the previous section of this article, capital account inflexibility is one of the factors that keeps small emerging economies from allowing pension asset managers to have a higher ratio of international investment in their portfolios. However, modern investment management techniques such as asset or stock index swaps, inflation index bonds and securitization can provide alternative investment strategies for countries with capital constraints.

#### *Regulatory Framework*

A key characteristic of recent approaches to pension fund reform is enhancement of the regulatory framework. In most instances this involves the creation of an independent social security supervisory authority that oversees pension fund companies and employers and sets criteria for participation, contribution levels, conflicts of interests, and rules concerning investments, switching and related matters.

For many countries, social security reform is only one element of financial development, which occurs alongside evolution of the capital market and modernization of the insurance and banking sectors. Though these countries lack the institutional and technical capacity, they are often tempted to develop independent and decentralized entities for regulating the different segments of the financial market. There are two problems with this approach. First, the countries are typically strapped for resources and thus cannot staff the independent supervisory entities with knowledgeable and well-trained officers who have the adequate resources. The second problem pertains to the lack of a consolidated regulatory framework

to mirror the conglomeration that exists in the financial sector. Generally the primary players in the financial sector are not divided by segment, and a few companies dominate the financial market. A centralized and consolidated structure provides regulators with a holistic view of the activities of these financial conglomerates.

#### *Regional System*

Small emerging economies could also consider adopting a regional system where a centralized regulatory or administrative mechanism would provide savings through economies of scale. In this structure each country would design its own pension system, contribution rates, retirement ages, and minimum guaranteed pension to fit its fiscal and demographic realities. Each country could also design and manage its own tax collection system. However, the countries would combine to form a regional network to solicit international bidders for the management of a combined portfolio. Individuals in each country would incur the same administrative fee.

The countries could also form a supra-structure for a regional oversight entity to promote efficiency, independence and reduced political interference in pension regulation. In formulating the regional oversight entity, it would be necessary to create a centralized commission to develop policy and a framework for the operations of the regional pension regulator. The commission could be made up of representatives from the central banks and governments of each participating country. Of course, if harmonization in other sectors is already being pursued by a group of countries, it could provide an appropriate platform for creating a regional pension structure.

### Conclusion

This article demonstrates that the old age crisis is also an issue for small emerging economies. It argues that the characteristics of small emerging economies limit their ability to reap the intended gains of recent alternatives for social security re-

---

## Social Security Reform

form. Policymakers should consider developing models for investment management that focus on cost reduction through centralization of collections rather than gains due to competition among AFPs. The article also suggests that policymakers consider developing a consolidated regulatory framework that mirrors the consolidation evident in the financial market. Regional cooperation among small neighboring countries should also be considered.

---

## The Use of Guarantees

*(from page 1)*

(6) the use of government guarantees or insurance

In most cases, the costs of allocating capital are not clearly understood. These costs include the probabilistic cost of making good on a guarantee or insurance by the government, the less-efficient functioning of financial markets, the lessened allocative efficiency of real resources, the loss of tax revenue to the central government. It is critical that these costs be considered in relation to their benefits before a decision to allocate capital is made. Too often, this analysis does not occur, due to the “hidden” nature of many of the costs.

The methodology for evaluating the economic effects of government credit programs requires a focus on the magnitude of the subsidy, not the volume of loan activity. If we view governments as equivalent to private financial intermediaries, then the costs of their lending activity, including administrative expenses and any reserve for expected default costs, should be fully identified<sup>1</sup>. The amount of the subsidy can then be measured as the net cost to the government.

The cost of the loan guarantee appears to be the most difficult to evaluate and disclose in the annual government budget.

## Estimation and Disclosure of the Cost of Government Loan Guarantees – The US Credit Reform

Based on the Credit Reform of 1991, the U.S. Government has introduced a good example of an effort to properly report and disclose guarantees and their costs on a Present Value/Actuarial basis as part of the Budget.

The Federal Government uses direct loans and loan guarantees as tools to achieve various program objectives, such as assistance for housing, farming, education, small business, and support to foreign governments. Before the enactment of the Credit Reform, in 1991, Federal credit programs were recorded in budgetary accounts on a cash basis. The cash basis distorts the timing of when costs are actually incurred and thus hinders comparisons of credit program costs with those of programs financed with grants. In fact, the cash basis cost of a direct loan in a fiscal year is equal to the cash-basis cost of a grant. The long-term cost of a direct loan, however, may be much less than a grant, because of loan repayments. Cash

ued as relatively costly, because the cash-basis recording does not recognize that many direct loans are repaid.

The US Credit Reform changed the treatment of credit programs so that their costs could be compared more accurately with each other and with the costs of other government spending. The two basic principles of the Credit Reform are:

- (1) the definition of the subsidy cost in terms of the Net Present Value (NPV) of cash flows over the life of a loan
- (2) the requirement that budget authority to cover the subsidy cost be provided in advance, before new direct loan obligations are incurred and new loan guarantee commitments made

The Credit Reform defines the subsidy cost of direct loans as the Present Value of disbursements and other payments minus estimated payments to the government (repayment of principal, payments of interest and other payments after adjusting for projected defaults, prepayment fees, penalties and other recoveries. It

---

**The US Credit Reform changed the treatment of credit programs so that their costs could be compared more accurately with each other and with the costs of other government spending.**

---

basis budgetary recording also implied a bias in favor of loan guarantees over direct loans. Loan guarantees appear to be free because cash-basis recording does not recognize that loan guarantees might default. Furthermore, direct loans are val-

defines the subsidy cost of loan guarantees as the Present Value of cash flows from estimated payments by the government (for defaults and delinquencies, interest rate subsidies and other payments) minus estimated payments to the govern-

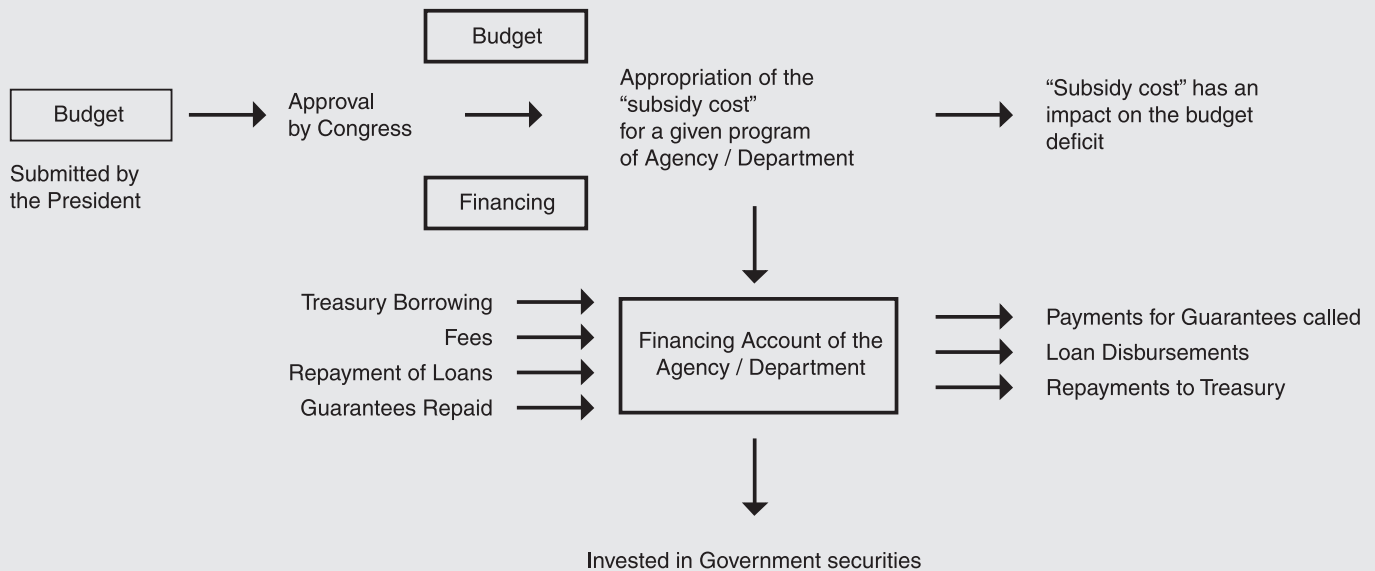
---

<sup>1</sup> The subsidy of a loan guarantee can be measured, just as it is in private institutions, as the cost of maintaining a reserve equal to the expected default costs.



## The use of guarantees

**Figure 1**  
**Flow Chart of the US Credit Reform**



*The Administrative Cost of managing the programs is charged to the Budget.*

ment (for loan origination and other fees, penalties and recoveries). The Present Value is calculated by discounting the cash flows at the average interest rate on marketable Treasury securities of similar maturity to the direct or guaranteed loan when the loans are disbursed.

The Office of Management and Budget (OMB) has the responsibility to ensure proper implementation of the credit reform, including calculation of subsidy costs for specific agencies. To provide a consistent, common approach to calculate the present value of credit program costs, OMB developed a software program that calculates the subsidy rate based on agency-generated estimates of cash flows and data from the government. The program also calculates the portions of the subsidy cost attributable to defaults, interest, subsidies, fees, and other subsidy components.

Agency-generated cash flows are entered into the program by means of an electronic spreadsheet. The program's basic function is to calculate the Net Present Value of these cash flows, by discounting them to the year funds are disbursed and dividing the amount of the

subsidy by the present value of the amount of the disbursement to obtain the subsidy percentage. Agency-generated cash flows are essential for determining subsidy costs. Changing data on the cash flows, such as the expected rate of defaults, modifies the subsidy calculation. Thus, the program for subsidy calculation is only as reliable as the data used in agency-generated cash flows.

Although the Credit Reform requires the use of Present Value to measure the subsidy costs of direct loans and loan guarantees for budgetary accounting and reporting, the law does not address financial statements and associated reporting. However, the Federal Accounting Standards Advisory Board (FASAB) concluded that integrating budgetary and financial accounting for federal credit programs would have significant benefits, as budgetary resources for direct loan and loan guarantee subsidies are required to be reported on a net Present Value basis. Statement of Federal Accounting Standards (SFFAS) No.2, Accounting for Direct Loans and Loan Guarantees, was issued in 1993, to provide accounting standards for federal direct loans and loan

guarantees that incorporate the subsidy calculation requirements. With the issuance of SFFAS No.2, subsidy calculations became important, not only for budgetary accounting and reporting purposes but also for financial reporting purposes. Figure 1 provides an illustration of the way the Credit Reform works, and demonstrates how the reform affects the presentation of the cost of guarantee by eliminating the presentation in the budget of the financing of the budget.

The assumptions are revisited annually for default rate, interest rate and other key variables, and the subsidy cost updated. The calculation of the cost of loan guarantees, as well as the recalculation, opens a number of issues related to the value of the guarantees that the government extends.

### Valuation of Guarantees

In the last 20 years, the literature has expanded the analysis on the calculation of the value of guarantees. On operational and policy grounds, it is very important that the value of the guarantee and the cost to the government is properly as-

*(continued on page 5)*

---

## The use of guarantees

sessed and that correct recording and disclosure are carried out.

In assessing the value of a guarantee or a counter-guarantee provided by the government of an emerging country we recognize that the guarantee covers specific risks that a private lender incurs in a particular private sector operation in the country. We also assume that the government is focusing on a single project and there is no diversification effect<sup>2</sup>.

Simulation and optimization techniques are appropriate methodologies to assess the value of a guarantee and its cost for the government to honor the expected default.

In the simulation process, we select the “output or target value” that we want to estimate as well as the probability distributions of the factors that we expect to have an impact on the target value. The cost of the guarantee to the government represents the target value, while interest rates, exchange rate, probability of default and level of coverage are identified as the most critical factors which affect the target value and for which probability distributions are specified. The simulation will provide a probability distribution of the target value, i.e., the cost of guarantee for the government. In this process, several iterations of the model generate distributions of possible outcomes, each time using different randomly selected sets of values for the probability distributions of the independent factors<sup>3</sup>. In effect, all the combinations of the values of factors are checked to simulate all possible outcomes.

The simulation and optimization combined follows some of the steps as in the traditional simulation technique outlined above. The target value to “optimize” is the minimum cost of the guarantee for the Government. The probability distributions of the factors are the same as in simulation. However, to include optimization, we introduce a range of values for some variables which can be adjusted: the percentage of guarantee, and the level of the fee. A crucial constraint is introduced

---

## Simulation and optimization techniques are appropriate methodologies to assess the value of a guarantee and its cost for the government to honor the expected default.

---

### Questions and Issues related to the use of the Government Counter-guarantee

- a. What has been the experience in MDB-supported projects that required a counter-guarantee of the government?
- b. Was the counter-guarantee disclosed? Was the cost of the counter-guarantee estimated and disclosed? Would the lack of disclosure of the government counter-guarantee be inconsistent with the IMF's requirement of budget transparency?
- c. What are the financial and accounting problems related to the issuing of guarantees in emerging countries?
- d. What are the political problems associated with the issuing of the government counter-guarantee? E.g., the fact that private lenders and ultimately private sector sponsors would benefit from counter-guarantee in a sector that the government is committed to privatize.
- e. How will the government counter-guarantee affect the lending of the MDB to the country?

in the model, specifically that the amount available for payment at termination be equal to the expected amount of default. The simulation and optimization technique will identify the values of the variables, which will lead to a probability distribution of the cost of guarantee that allows the government to meet the obligation of the expected default.

The two techniques described above—now readily available through commercial software<sup>4</sup>—have been used to evaluate the cost of guarantees related to one specific project finance operation and price it according to the risk of that operation. It would be possible to make the model more sophisticated and introduce other factors that influence the cost of the guarantee and evaluate it correctly. The valuation of the loan guarantee and the cost for the government seems one of the crucial aspects related to the guarantee programs that various Multilateral Development Banks (MDBs) have introduced in the early 1990s.

### The Use of the Government counter-guarantee in the Guarantee Programs of Multilateral Development Banks

In recent years, the World Bank, the Inter-American Development Bank and other MDBs have introduced guarantee programs to cover selected risks with or without the counter-guarantee of the governments. These programs are directed to private sector lenders for infrastructure projects.

The Inter-American Development Bank as well as the Asian Development Bank (AsDB) and the European Bank for Reconstruction and Development (EBRD) can provide a guarantee with or without the counter-guarantee of the government. During a technical seminar held in Washington on May 25, 1999, experts from the various MDBs reviewed their experience with the use of guarantees<sup>5</sup>.

*(continued on page 8)*

---

<sup>2</sup> An extended paper on this subject is under preparation.

<sup>3</sup> The model can also incorporate correlations among factors

<sup>4</sup> @RISK, Risk Analysis and Simulation, Add-In for Microsoft Excel or Lotus 1-2-3, Palisade Corporation NY, 1995. Risk Optimizer, Simulation Optimization for Microsoft Excel, Palisade Corporation, Newfield, NY, 1998.

<sup>5</sup> See the web page of the Group of Multilateral Financial Institutions (MFI) <http://www.worldbank.org/html/fpd/privatesector/mfi/index.html>.

## The use of guarantees

**Table 2**  
**Guarantees Issued by Multilateral Development Banks**  
*(and Government Treatment of Counter-Guarantees)*

Institution	Projects Guaranteed	Nominal Value of Guarantee (US\$ m)		Total Project Cost (US \$ m)	Counter-Guarantee Issued? (Y/N)
		Partial Risk	Partial Credit		
Asian Development Bank	Indonesia		18.75	200	Y
	Papua New Guinea		5.5	29.65	Y
	India		50	430	Y
	China		17.23	118	Y
	China		6.52	158	Y
	China		12.26	139	Y
	Philippines		142	386	Y
	Sri Lanka		50	55	Y
	Thailand		730	1,000	Y
	Sri Lanka		65	70	Y
		<i>Sub-total</i>		<i>1,097.26</i>	<i>2,585.65</i>
European Bank for Reconstruction and Development	Hungary		12	296	N
	Hungary		3.3	360	N
	Hungary		102	360	N
	Russia	38		127	Y
		<i>Sub-total</i>	<i>38</i>	<i>1,17.3</i>	<i>1,143</i>
International Bank for Reconstruction and International Development/ International Development Agency	China		59	1,100	Y
	Philippines		100	1,333	Y
	Pakistan	240		1,800	Y
	China		64	1,600	Y
	Jordan		50	217	Y
	China		50	2,900	Y
	Pakistan	75		630	Y
	Lebanon		100	498	Y
	Morocco	176		1,483	Y
	Russia	100		N/A	Y
	Ukraine	100		N/A	Y
	Thailand		300	4,885	Y
	Cote d'Ivoire	30		233	Y
	<i>Sub-total</i>	<i>721</i>	<i>723</i>	<i>16,679<sup>3</sup></i>	
Inter-American Development Bank	Colombia		30	125	N
	Argentina		75	583	N
		<i>Sub-total</i>	<i>105</i>	<i>708</i>	
<b>TOTALS</b>		864	1,937.56	21,115.65	

Source: from MFIs

- <sup>1</sup> EBRD figures do not include Multi-Project Facilities where in many cases EBRD obtains a full payment guarantee for its equity or debt from the sponsors with a “specified event carve out” for political risks. EBRD also sometimes obtains comfort letters from the State or the municipality.
- <sup>2</sup> The Cote d'Ivoire guarantee is under the IDA program; the other twelve are IBRD guarantees.
- <sup>3</sup> Sub-total does not include the Russian and Ukrainian projects for which total project costs are unavailable

---

## The use of guarantees

Table 1 shows the experience of MDBs in the last 5 years with the implementation of programs of partial risk and partial credit guarantees, with and without the government counter-guarantee, for projects intended to support private investors willing to operate in emerging markets. The leverage of the guarantee is very significant, i.e., the total cost of the project relative to the amount of the guarantees is equal to 20 to 1 for the World Bank; 2.5 to 1 for the Asian Development Bank; 10 to 1 for the European Bank for Reconstruction and Development; and 7 to 1 for the Inter-American Development Bank. The IDB is the only MDB that has not used a government counter-guarantee. One can argue that the potential of the guarantee program is high, but its impact to date has been limited.

When MDBs provide a guarantee, taxpayers in industrial countries underwrite the risks related to the guarantee. When the MDBs guarantee is counter-guaranteed by the host government of an emerging country, then the taxpayers in the emerging country are underwriters and can be seen as assuming the risks as a last resort. It is interesting to note that in releasing counter-guarantees related to

### Invitation to Readers

We welcome contributions from our readers. Articles should be no more than 4 double-spaced pages, preferably in English, and in WordPerfect or Word files. Topics on infrastructure finance, management and regulation, financial markets, and the private sector are to be highlighted in the Bulletin.

Please submit articles, comments, announcements, or other contributions to e-mail: IFMMAIL or to IFM BULLETIN, Stop W-0508.

---

## Multilateral Development Banks have introduced sophisticated programs of partial credit and partial risk guarantees, with and without government counter-guarantees, aimed at facilitating the flow of financial resources to support private sector participation in projects, particularly in infrastructure.

---

projects with MDBs, there is scant evidence that governments of emerging countries have estimated or disclosed the existence of the guarantee and its cost.

### Considerations

The use of guarantees or counter-guarantees is one of the instruments for social allocation of capital by which governments direct the flow of savings to defined objectives. In any form of intervention by governments, the function of the financial markets is altered and there are costs to be weighed against the benefits, as well as against the cost and benefits of other programs. The main factors to evaluate are the opportunity cost to taxpayers, to other borrowers, to savers, to the efficiency of financial markets, and to the economic and/or social contribution forgone by the rejection of other projects. Obviously, the decision-making process is easier if these costs can be ignored. As society will bear these costs in one way or another, they should be analyzed at the time of a decision. Disclosure and transparency of the decision-making process, as well as of the cost of government intervention are the correct approach, even when the disclosure and the assessment of the cost/benefits are rather complex process<sup>6</sup>.

From a policy point of view, the cost of

a stand-alone guarantee or counter-guarantee can be very high, considering the limited information and assuming that the government is not able to diversify the risk covered. Therefore, the government may be induced to subsidize the cost of the guarantee, or start a massive program of guarantees to diversify, (i.e., the subsidy can be seen as the cost of the coverage, which the government bears, because the risks are not diversified away). In reality, the only way that the government can diversify away the risks is through the tax system and taxpayers would be forced to bear the risks without appropriate remuneration. Government funding or intervention is cheaper than private finance, but only because taxpayers that are the ultimate providers of insurance to the government are not remunerated for the risk and the contingent liability that they assume. In reality, the government is not in the best position to do something that the market can do more efficiently.

From an operational point of view, the US system represents a tremendous advance in evaluating and disclosing the hidden costs of loan guarantees, but is not fully applicable to the release of guarantees for projects in emerging countries. The government of the emerging country has to deal with the exchange risk, which does not exist in the case of the US. The

---

<sup>6</sup> The use of the Government guarantee, or counter-guarantee for risks associated with private sector investments in infrastructure has to be considered with a number of "caveats".



---

## The use of guarantees

government of the emerging country has to ensure that the funds invested correspond to the amount needed to cover default, and to reduce this risk the government may have to invest in a currency other than its own. In addition, governments are not best placed to recover claims upon default, a function that increases the cost of releasing guarantees. Moreover, the loan guarantee program of the US covers default or credit risk for a multiplicity of operations, while the government of an emerging country should fo-

cus more on policy risk, e.g., regulatory risk and on a limited number of operations.

Multilateral Development Banks have introduced sophisticated programs of partial credit and partial risk guarantees, with and without government counter-guarantees, aimed at facilitating the flow of financial resources to support private sector participation in projects, particularly in infrastructure. For MDBs, this represents an opportunity to advise governments not only on how to effectively

use limited guarantees to attract private investors, but also on the implications of the release of guarantees and how to assess and disclose the expected cost.

Simulation and optimization models should guide governments in calculating the cost of loan guarantees and disclosing that cost. The introduction of proper recording of the cost of government-sponsored programs helps in creating a culture of transparency and disclosure and it makes the government understand the issues at stake.

## The Financial Markets Strategy\* of the Inter-American Development Bank

The Inter-American Development Bank's work in financial market development has been guided by the following five goals:

- Fostering the emergence of new and varied mechanisms for pooling longer term savings in the domestic markets.
- Developing financial instruments and infrastructure to channel financing, both domestic and foreign, into private sector investment.
- Expanding the access to financial services by potential users of those services, especially smaller businesses.
- Providing maximum efficiency, mainly by encouraging competition among the providers of financial services.
- Assuring adequate prudential regulation of the financial system.

The Financial Market Strategy proposes an increased emphasis on traded markets, moving away from the bank-dominated systems that exist in most countries in Latin America and the Caribbean. Additional goals would include:

- Supporting the establishment of new institutions, instruments and markets that will allow for efficient risk transfer mechanisms.
- Motivating an increase in financial market liquidity through the development of effective secondary markets.
- Promoting financial market integration regionally, sub-regionally and at the country level.

\*The Financial Markets Strategy was approved on Sept. 8, 1999. For the full text of the strategy, please contact Juan Jose Durante (tel: 202-623-1639; email: juanjosed@iadb.org)

## Editor's Desk: Evolution of US Banking Regulation—Death of Glass-Steagall?

For the past twenty years there has been a constant battle in the US to repeal Glass-Steagall, the post depression legislation that led to the separation of banking from brokerage and insurance activities. This battle heated-up over the past three years when in 1997 Bankers Trust purchased Alex Brown Inc. leading to the first U.S. Bank to acquire a company with its principal activities in underwriting.

Further fuel was added with the 1998 merger of Travelers Group, a major player in brokerage and financial services, with Citicorp, then the nation's second largest bank.

Glass-Steagall was introduced in 1933 based on the fears that the 11,000 of America's banks, that collapsed was due to speculation on the stock market. While many have argued that this rationale was unfounded, Glass-Steagall has withstood the test of time. More recently, many in the industry have called for the repeal of Glass-Steagall in recognition of the fundamental changes that have taken place in the global financial industry. In October 1999, with the approval by the U.S. Congress, of the Financial Services Modernization Act (FSMA), the final nail seems to have been inserted in the coffin of Glass-Steagall. The FSMA will now permit a financial entity to engage in insurance, brokerage and banking activities.

Many in the industry view the impact of the FSMA to be felt in several arenas. First, for customers this could represent legitimate "one-stop shopping" for financial services that could lead to lower rates and fees. Also on Wall Street, one could also envisage more consolidation and merger activities particularly for single service entities that will attempt to stave off competition from large diversified conglomerates. There is also some speculation that FSMA creates a structure to make US banks better able to compete with universal banks in Europe and Japan, who have historically not have to endure the limits imposed by Glass-Steagall. Detractors of the FSMA point to the potential contagion effects that exist given the integration within the financial system and the resulting liability to tax-

payers in the event of a bailout. Also there is some concern whether the new law endangers community lending program for impoverished areas and others point to the legitimate concern over the use of private information that would now make a decision for credit intricately linked to the acquisition of insurance or other similar services.

A practical issue untouched by the new legislation pertains to the regulatory environment within which the new financial landscape will exist. Currently, in the US, two Federal bodies regulate banks: the Federal Reserve and the Office of the Comptroller of the Currency, with these two entities claiming primary responsibility for regulating banks. There is no federal regulator for insurance companies and the securities industry is regulated by the Securities and Exchange Commission and the Commodities and Futures Trading Commission. The jury is thus still out on the working of a consolidated financial market minus consolidated regulation.

Regardless of the outcomes, FSMA represents a major step in the evolution of banking in the US and ushers in an expectant post Glass-Steagall world.

**1933:** Glass-Steagall Act is introduced following the failure of several US banks in the Great Depression. Glass-Steagall prohibits banks from underwriting stocks or bonds, establishes the FDIC, and expands the role of the Federal Reserve.

**1956:** The Bank Holding Company Act created additional restrictions on the activities of banking institutions.

**1978:** The International Banking Act increases competition from foreign banks as the legislation makes it mandatory for foreign banks to establish federal or state-chartered branches or agencies.

**1980:** The Depository Institutions Deregulation and Monetary Control Act results in deregulation of the activities of the banks as they are all federal limits on the payment of interests on deposits are eliminated and interest-bearing checking is spawned.

**1982:** The Depository Institution Act provides greater flexibility and latitude in commercial lending and also allows thrifts to relax their standards for some activities such as speculative real estate developers.

**1989:** In response to the Savings and Loan crisis the Resolution Trust Corporation (RTC) is formed to intervene and temporarily manage insolvent savings and loans. By the end of ensuing year, the RTC is managing over 300 thrifts.

**1990:** Major blow to Glass-Steagall as J P Morgan receives permission from the Federal Reserve to underwrite securities up to a limit of 10% of its revenue.

**1996:** The Federal Reserve allows banks to underwrite securities up to 25% of its revenue.

**1998:** Travelers Group a major provider of insurance and stock brokerage services and Citicorp, the country's second largest bank, go public with a plan \$70 billion merger. The merger is illegal unless there are changes in Glass-Steagall within two years and thus authorized by the regulatory authorities.

**1997:** Bankers Trust (currently owned by Deutsche Bank) buys Alex. Brown Inc., a major brokerage and investment banker is the first attempt two wed two businesses once firmly divided by Glass-Steagall.

**1999 (Oct.):** Financial Services Modernization Act (FSM) represents an agreement between Congress and White House agree to repeal Glass-Steagall. FSM in effect reduces the barriers between financial entities engaging in banking and financial services.

## Reviews

**Financial Markets and Development, The Crisis in Emerging Markets**, *Proceedings of The Brookings Institution/World Bank Conference on Financial Markets and Development*. This publication examines the causes of the recent financial crises in East Asia and Russia, addresses policy concerns and proposes solutions. Some of the specific topics that are covered include corporate governance and institutional investors' activity in emerging markets. (Available from World Bank InfoShop)

**Pension Funds in Infrastructure Project Finance: Regulations and Instrument Design**, *Antonio Vives, Journal of Project Finance, Summer 1999*. This paper looks at some of the issues that need to be considered to create a link between on-going pension fund reform and the ability for project financing for infrastructure projects. The paper encourages the reader to view pension funds as a viable financing alternative and describes the regulatory changes that allow pension funds to invest in infrastructure projects.

**Safeguarding Prosperity in a Global Financial System: The Future of International Financial Architecture**, *Report of an Independent Commission Sponsored by the Council of Foreign Relations*. This publication reviews the main factors that create banking, currency and debt crises and provides recommendations for preventing and resolving these crises. The report also takes on the contentious issue of the role of multilateral financial institutions in the context of the new international financial architecture. Available from the Institute for International Economics.

## Additional Reading:

### Government Guarantees:

Lewis, C.M. and Ashoka Mody, *The Management of Contingent Liabilities: A Risk Management Framework for National Governments*, World Bank, 1997.

General Accounting Office (GAO), *Credit Reform, Review of OMB's Credit Subsidy Model*, 1997.

RISK OPTIMIZER, *Simulation Optimization for Microsoft Excel*, Palisade Corporation, Newfield, NY, 1998.

Vogel, Robert C. *Costs and Benefits of Loan Guarantee Programs*, *The Financier*, Vol. 4, No. 1 and 2, February-May 1997.

### Pension Reform for Small Economies:

Crane, Dwight, *The Global Financial System: A Functional Perspective*, Harvard Business School, 1995.

Aponte Reyes-Ortiz, Guillermo (1998), *Reforma del Sistema de Pensiones: El Caso de Bolivia*, Harvard Institute of International Development, July 17-18, 1998.

IFM **BULLETIN**

**Mailing Label**