

Self-Insurance, Reserve Pooling Arrangements, and Pre-emptive Financing

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Introduction

- New environment for emerging markets (EMs)
- Need for pre-emptive financing
- Options:
 1. Foreign exchange reserve accumulation
 2. Contingent financing
 - Private CCLs
 - Liquidity facility at the IMF
 - Reserve pooling arrangements
- Concluding remarks

The New Environment...

- Increasingly open capital accounts
- Rise in cross-border capital flows
- Possibility of rapid reversals in capital flows, and contagion from global and regional events
- Rapid portfolio shifts that may entail huge exchange rate overshooting to elicit appropriate current account responses
- Large balance sheet effects
- Large potential financing needs

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...and the Implications for EMs

- since asset prices are based on future cash flows, managing expectations of domestic and foreign investors is very important
- much greater uncertainty attached to estimates of financing needs
- given the speed with which capital can move, financing may need to be provided in anticipation of need
- important role for instruments and mechanisms that will give EMs access to liquidity to deal with capital flow reversals and contagion

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Options for liquidity management

1. Foreign exchange reserve accumulation
2. Contingent financing
 - Private Contingent Credit Lines (CCLs)
 - Liquidity facility at the IMF
 - Regional reserve pooling arrangements

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Reserve Accumulation

Benefits:

- assured availability of funds and freedom of use
- a sizable reserve stock may increase access and lower the cost of funding in international markets

Costs:

- opportunity cost of holding reserves may be large; wide range of estimates depending on metrics used

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Issues to consider

- Measure of reserve adequacy?
 - use a metric that combines net imports, debt service, and broad money
 - take account of the institutional structure, risks in private and public balance sheets, net worth, available collateral, access to financial markets, track record, and the global financial environment
- To what extent can interest rates and exchange rates adjust in response to changes in the external environment?

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Private CCLs

- **Characteristics of private CCL facilities**
 1. maximum amount available over a given period
 2. interest rate that will apply to the drawings
 3. fees charged by the lender, e.g. an upfront commitment fee, a service fee on the borrowed amount, a usage fee on the undrawn portion,...
 4. collateral
 5. an escape clause, called the material adverse change (MAC) clause

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Sovereign CCL Example: Argentina

- CCL set up in December 1996 with a consortia of 13 banks for US\$ 6.1 billion
- renewal: automatically every quarter until tapped
- collateral: Argentinean government securities
- repayment period: up to 2 years
- worked like a repo operation with pre-set terms:
Sale of pre-specified bonds at a pre-established price.
Repurchase price = original price + LIBOR + spread
depending on the type of bond offered as collateral
- fee structure: commitment fee of 0.31% (annualized)
payable every quarter
- MAC clause: banks could withdraw the arrangement if Argentina defaulted on any foreign debt service

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Sovereign CCL Example: Mexico

- CCL set up in November 1997 with a consortia of 33 banks from 10 countries for US\$ 2.67 billion
- CCL was for 1 year, with the option of one renewal
- collateral: none
- repayment period: 18 months after withdrawal date; no prepayment penalty.
- interest rate linked to sovereign credit rating
- spread over 3-month LIBOR based on BB/Ba2 sovereign credit rating: (i) 50 bp for the first two quarters; (ii) 75 bp for the third and fourth quarters; (iii) 100 bp for the last two quarters
- fee structure

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Issues to consider

- will a syndicate of private banks be willing to provide credit to a country dealing with a capital flow reversal and/or a possible credit downgrade
- prequalification vs. terms associated with drawings
- conditions under which CCLs can be drawn
- conditions for renewal of CCL
- dynamic hedging
- credit derivatives market

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A new IMF facility?

- liquidity support—provide increased assurances of the availability of IMF resources for a *potential* BOP need
- IMF seal of approval and its catalyzing role for other sources of finance
- contribute to reducing the probability of a crisis
- precautionary arrangements and incentives to adopt better policies

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IMF CCL facility, 1999-2003

Characteristics:

- funds committed for one-year on a standby basis
- no formal access limit, but access expected to be about 300-500 percent of quota
- repayment would be 12-18 months from date of each disbursement
- the rate of charge would vary between 150 and 350 basis points over the SDR rate, depending on duration of the drawing

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IMF CCL facility, 1999-2003 (contd.)

- Four qualification criteria:
 1. No expected need for IMF resources—except because of contagion
 2. A positive assessment of policies; and progress toward internationally accepted standards
 3. Constructive relations with private creditors and progress towards limiting external vulnerability
 4. A satisfactory macroeconomic and financial program and a commitment to adjust policies

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Reasons CCL was not used

- standards for qualification were set too high; it limited access to cases where only contagion could lead to BOP need
- country request for a CCL could be viewed as a sign of weakness
- risk of a negative signal from losing eligibility
- uncertainty whether access would be sufficiently automatic in the event of need

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New liquidity facility: Design Issues?

Fundamental trade-off:

prequalification (ex ante conditionality) vs. (ex post conditionality) terms associated with drawings

- Is it feasible to combine automaticity, reasonable access, with some qualification standards to create a facility that will serve emerging market liquidity needs and provide appropriate safeguards to the IMF?

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New liquidity facility: Design Issues?_(contd.)

Prequalification criteria:

- the higher the standards for prequalification the greater the automaticity in drawings
- need for selectivity if eligibility is to be taken as a credible signal of good policies and a commitment to reduce remaining vulnerabilities
- qualification criteria may need to combine objective criteria and judgment
- no immediate need for resources

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New liquidity facility: Design Issues?_(contd.)

Access limits:

- scale of financing
- size of first and subsequent drawings

Drawings from the facility:

- speed of disbursement; activation review for first drawing (and subsequent drawings)?
- periodic reviews or pre-set ranges for key variables, instead of regular monitoring?

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New liquidity facility: Design Issues? (contd.)

Other issues:

- disqualification would send a negative signal that a country has gone off-track and/or is no longer eligible to access facility
- can access be interrupted and then re-established after appropriate corrective actions are taken
- potential for additional access under traditional IMF lending arrangements
- monitoring of IMF's liquidity and overall exposure for precautionary financing

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Reserve Pooling Arrangements

Benefits:

- lower costs through co-insurance—risk diversification
- may deepen multilateral dialogue within the club
- possibly greater automaticity
- complements IMF resources and crisis prevention role

Costs:

- operating costs, including the costs of a surveillance system

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Issues to consider

- does the pooling arrangement truly diversify risks?
- to what extent does it provide assured funding?
- seniority of claims relative to IFIs
- pool conditionality and its relationship to IFI conditionality
- overlapping mandates, and coordination of decision making with other IFIs

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IMF support for regional pools

- facilitate the formation of reserve pools
- link to IMF arrangements
- policy surveillance and signaling advice
- coordination in crisis prevention

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Concluding Remarks

- Liquidity requirements—level and variance?
- What combination of self-insurance, private insurance and co-insurance to use?
 - self-insurance: greatest flexibility and certainty, but may be expensive
 - contingent funding: some uncertainty and less flexible, but is less expensive
- How should a new IMF liquidity facility be designed?
- What role should reserve pooling arrangements play in crisis prevention?