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

…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
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

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
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?

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
**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
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

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
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

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 toward limiting external vulnerability
  4. A satisfactory macroeconomic and financial program and a commitment to adjust policies
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

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?
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

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?
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

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
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

IMF support for regional pools

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