European Bank
for Reconstruction and Development

Jean Lemierre
President

Ms Daniele Nouy
Secretary-General of the Basle Committee on Banking Supervision
Basle Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basle
Switzerland

25th May 2001

Dear Ms Nouy,

Comments on the new Basle Capital Accord

The European Bank for Reconstruction and Development ("EBRD") strongly supports the proposed changes which encourage improvements in internal risk measurement and management, greater transparency and market discipline, which together improve the operating environment for all participants.

Furthermore, the new framework supports a critical element of the EBRD's particular mandate, namely to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the central and eastern European countries by mobilising private sector capital.

Whereas capital adequacy for multilateral development banks ("MDBs") is not directly affected by capital requirements for commercial entities, it is our intention, however, to highlight the aspects of commercial requirements that most directly impact the effectiveness of multilateral development banks.

Specifically, we are concerned, based on recent feedback from our commercial co-financiers, that in areas where the new proposals are unclear, banks will apply a conservative treatment. Project finance and country risk are two specific areas that impact our business and which are currently unclear.

Specific elements of the most recent proposals which will encourage appropriate development of our markets, and which we strongly support, include (a) the removal of the 150% automatic charge for unrated exposures in the standard approach and (b) the removal of the country risk ceiling, which will allow more accurate risk

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assessment of well-run companies that happen to be located in emerging market economies. Taken together, these significant changes in the approach will, we believe, encourage more accurate risk assessment and will support the flow of capital and credit into these countries.

Specifically, we request that the Committee consider:

- assigning a standard method risk-weighting for so-called MDB "B loans", and in this note, based on our experience, we set out a case for assigning a weighting of less than 100% for MDB B loans in the standard approach;
- stating in the final Accord that, as has been the practice to date, country risk provisioning is not required for MDB B loans; and
- affirming in the Accord that for internal models, the implicit political risk mitigation provided by MDBs should be treated at least as favourably as explicit political risk guarantees provided by high quality insurance providers.

This note and the attached articles elaborate on the risk factors that regulators and commercial banks should consider when assessing their exposure to B loans.

We would welcome the opportunity to discuss our thoughts in further detail at your convenience.

Yours sincerely,

Attachments:

1. Paper on the risk associated with B loans of Multilateral Development Banks, prepared by the EBRD, May 2001;
   incorporating as annexes:
2. Excerpt from Standard and Poor's Creditweek, 30th June 1999: "How preferred creditor status support enhances ratings"; and
3. Excerpt from Standard and Poor's Creditweek, 25th April 2001: "B loans and political risk insurance: different roads to the same destination".

cc: James Wolfensohn, President, The World Bank
Peter Woicke, Executive Vice President, International Finance Corporation
Enrique Iglesias, President, Inter-American Development Bank
Tadao Chino, President, Asian Development Bank

European Bank
for Reconstruction and Development

THE RISK ASSOCIATED WITH

B LOANS

OF MULTILATERAL DEVELOPMENT BANKS

Paper prepared for the
Basle Committee on Banking Supervision
Bank for International Settlements

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INTRODUCTION

The purpose of this paper is to present to the Basle Committee on Banking Supervision the facts that impact risk reduction on commercial bank holdings of B loans of multilateral development banks (MDBs).[1] In the past, supervisors have reflected this risk reduction by according these loans favourable capital adequacy treatment compared to commercial loans with otherwise similar commercial risk characteristics (but without MDB participation).

This is an important area for MDBs, as commercial bank strategy is linked to capital costs and a harsh regulatory requirement could lead banks to decide that it is too expensive to book emerging markets project finance assets. The EBRD is required by the Agreement Establishing The European Bank For Reconstruction And Development to involve other sources of financing in its operations, and to this end commercial banks are the EBRD's main co-financing partners. Co-financing has the dual benefit of introducing borrowers from emerging markets to the international markets and of promoting foreign direct investment in these emerging markets.

As the MDBs specialise in emerging market project finance, and as borrowers rely in many cases on the ability of MDBs to syndicate a portion of the senior debt (on a pari passu basis) in instruments called B loans, adverse capital adequacy treatment of B loans would be severely detrimental to private sector emerging market capital inflows to emerging markets. Most importantly, any adverse change in the capital adequacy treatment of B loans may not reflect the true risks of the underlying assets.

Accordingly, this paper addresses the following points:

- Background to the MDB B loan;
- How the MDBs' preferred creditor status mitigates against political risks;
- How bank regulators have treated B loans, for capital adequacy purposes, in the past;
- Future regulatory treatment;
- The write-off experience of the EBRD.

[1] Multilateral Development Banks, also known as International Financial Institution or IFIs, so-called because their shareholders are member countries and other international organisations or intergovernmental agencies.

1. THE A/B LOAN STRUCTURE OF MULTILATERAL DEVELOPMENT BANKS

1.1. BACKGROUND

Despite their vast scale, private international capital flows to emerging market economies typically lack an adequate framework of domestic institutions to support cross-border term lending. As a result, the international financial system contains strong biases towards short-term debt finance, especially towards intermediation through local banks.

Where the enforcement of creditor rights often offers poor legal protection and the risk of financial instability is high, international investors typically rely on the liquidity of bank placements and the ability to withdraw funds quickly from their counterparties and to repatriate them. With the rapid expansion of international capital flows over the past decade, this bias toward short-term debt intermediated by international and local banks has become a significant source of global financial instability.

It is in the context of such instability and the weakness of institutions to support international capital flows that the role of A/B loans[2]) provided by MDBs should be considered. Essentially, the A/B loan structure allows commercial lenders to share the benefit of the MDBs' "preferred creditor status". (See section 1.3 for the mechanism of this structure).

This preferred creditor status, whilst it does not eliminate all country/political risks, has proven over many years to be an effective mitigant against most such risks, including convertibility and transfer risks, breach of contract (by government or quasi-governmental bodies), expropriation, war and civil unrest.

The A/B loan structure used by the MDBs serves both to lengthen the maturity structure of private lending beyond the short term (thus contributing to stability in and of itself) and to broaden the range of participating institutions. This expansion of finance in emerging markets is achieved by the mitigation of certain risks by the MDBs. In countries that are potentially vulnerable to financial or currency crises, participation in the preferred creditor status of MDBs offers an alternative to the liquidity and the ability to "run" that private international investors often seek as a (in many cases ineffective) risk mitigation device.

The A/B loan financing activities of the MDBs, moreover, help to promote the institutional foundations that will in the future support widespread development of medium- and long-term debt financing of private counterparties in emerging markets.

[2] Although most MDBs use the terms A loan and B loan, certain MDBs use the term Direct Loan and Complementary Loan, e.g. under the AsDB's Complementary Financing Scheme ("CFS"). However, for convenience, the paper will refer mostly only to the terms A loan/B loan.

Through the careful design of private sector projects and the insistence on sound business practices and corporate governance in their investee companies, the MDBs demonstrate and promote the wider adoption of business practices by local enterprises that are necessary for them to gain access to subsequent spontaneous and stable private financing.

In their policy dialogue with authorities in their countries of operations on the investment climate, the MDBs also emphasise the importance of adequate legal protection of creditor and shareholder rights, including fair judicial enforcement.

The A/B loan financing activities of the MDBs are, therefore, both a source of financial stability within the current (weak) institutional framework for cross-border emerging markets lending and an instrument for promoting the domestic infrastructure that is necessary to promote greater global financial stability over the long term.

At the same time, it is recognised by the MDBs that A/B loan structures must be used prudently and responsibly. Excessive levels of debt owed to preferred creditors are inimical to the interests not only of the borrowing country but also to the commercial lenders that participate in MDB B loans. In particular, high levels of debt owed to preferred creditors could significantly complicate debt restructuring in situations of sovereign default, although B loans have always represented a relatively small percentage of such total preferred debt amounts. The MDBs are aware of the risks associated with excessive levels of preferred debt and as a result monitor their respective exposures of both A and B loans and are careful to extend selectively the B loan umbrella[3].

1.2 PREFERRED CREDITOR STATUS

Experience has shown that governments and central banks give priority to servicing certain obligations over others, when the sovereign state is unwilling or unable to service all of its external debt as a result of hard currency shortages at the national level. In such circumstances, obligations to MDBs are usually the last to be put into default. The shareholder countries of the MDBs grant this "preferred creditor status" to the MDBs (and the IMF) for several reasons.

In return for granting preferred creditor status, host countries benefit in certain ways, e.g.:

- MDBs are often the only source of new lending to countries in financial distress. Whilst MDBs may sometimes be reluctant to provide new funds to a country that has defaulted to commercial creditors, MDBs will nonetheless often be the first to resume new lending once debts have been renegotiated and arrears cleared.
- It is the mandate of MDBs to continue to lend in good times as well as in times of financial distress, to act as a catalyst in mobilising resources from others, and to demonstrate that this lending can be a profitable and successful business. This

[3] Sometimes also referred to as the "halo".

lending would not be possible, especially in difficult times, without preferred creditor status.

At the same time, the host countries have certain incentives which encourage them to respect the preferred creditor status of the MDBs, e.g.:

- As MDBs often have policies that prevent them from lending to countries that have gone into arrears on MDB debt, there is a powerful incentive for countries to stay current on their MDB obligations even during periods of financial difficulty.
- As a policy, MDBs will not participate in country debt reschedulings. Therefore, going into arrears would not represent the first step towards obtaining debt relief through rescheduling, which a debtor country might hope for.
- Defaults to MDBs will usually result in a halt on disbursements of approved (but as yet undisbursed) funds[4]. These funds can be substantial both in size and nature, e.g. funds from MDBs could in certain cases be at lower interest rates and will almost certainly have longer tenors than official bilateral and commercial creditors' loans. Defaults also usually trigger an acceleration of payments.
- MDBs often coordinate their lending so that default on the obligations to one MDB would result in potential default on the obligations to other MDBs.
- Being in arrears to an MDB is a strong deterrent to any future loans from official bilateral or commercial creditors, as well as placing severe obstacles, if not a complete block, in the way of a country's commercial debt rescheduling efforts.

The nature of preference that preferred creditor status affords an MDB differs between public sector and private sector obligors. With respect to the obligations of a sovereign state towards the MDBs, the preference is afforded relative to other claimants against both the government and the central bank. With respect to the obligations of private sector projects and borrowers, to the extent that such entities have adequate local currency to purchase the foreign exchange to make their scheduled debt service payments, preference is given relative to other claimants for conversion of local currency into foreign exchange to make these payments.

Preferred creditor status is necessary for many lenders, be they MDBs or private commercial banks, to consider taking a medium- or long-term exposure to a private commercial borrower in most emerging markets, where the risks of financial instability may be high. Preferred creditor status provides risk mitigation (although not guarantees) against events such as:

- foreign exchange moratoria;
- general country debt rescheduling;
- requirement to make mandatory new money obligations as a result of a general country debt rescheduling;

[4] It may be useful to point out that an MDB will not usually halt disbursements on public sector loans in the event of a private sector default, if such default is for commercial reasons. Even if such default were perceived to have been for political reasons, the MDB would also not necessarily halt disbursements on its public sector loans. The precise circumstances would dictate the course of action. In other words, MDBs' private sector loans and public sector loans are not usually cross-defaulted. Nonetheless, an MDB would react vigorously to political interference on any remittances due to it, whether such interference related to public sector or private sector loans.

- currency convertibility; and
- foreign exchange transfer.

The MDBs have been vigilant in asserting and protecting the preferred creditor status of their loans. A critical and successful test was the Latin American debt crisis of the 1980s. Recently, during the Asia crisis of 1997 and the Russia crisis of 1998, preferred creditor status has been tested and has been honoured by borrowing countries.

1.3 THE B LOAN AND THE LENDER OF RECORD STRUCTURE

Under a typical A/B loan structure, an MDB acts as the lender of record, i.e. sole contractual signatory with the borrower under the loan agreement. The MDB remains the lender of record for the entire amount of the loan. Accordingly, the entire amount of the loan is accorded the preferred creditor status due to the lending MDB.

In such a loan agreement, the MDB contracts to provide a portion of the loan for its own account. This portion is called the A loan. The remainder, i.e the B loan amount is syndicated to commercial lenders, usually banks, without recourse to the MDB. This is achieved by the B lenders entering into a participation agreement with the relevant MDB. This participation agreement governs the relationship between the MDB and the B lenders.

The A loan and the B loan are neither technically nor legally two separate loans. Rather, they are two portions of the one loan, and the sole lender under that loan is the MDB[5]. It is important to note that, despite the nomenclature of A loan and B loan, the two portions are in fact two parts of one pari passu senior debt obligation. The term "A loan" does not denote seniority over the "B loan".

Five MDBs are the main originators of the B loan instrument. They are:

- IFC[6], since the 1960s;
- AsDB[7], since the 1970s;
- IaDB[8], since the 1970s;
- EBRD[9], since 1991;
- CAF[10], since 1997.

[5] In the case of AsDB, the documentation for a CFS loan often provides for two separate loans: a direct loan on AsDB's account and a complementary loan with AsDB as the lender of record but funded entirely by market institutions, and this has been as effective as a single loan document in terms of providing PCS to the participants.
[6] International Finance Corporation, a member of the World Bank Group.
[7] Asian Development Bank.
[8] Inter-American Development Bank.
[9] European Bank for Reconstruction and Development.
[10] Corporacion Andeana do Fomento (Andean Development Corporation).

The IFC has accounted for 70-75% of all B loans originated by MDBs over the past five years and the EBRD 15-20%.

The ratio of the A loan to the B loan varies amongst the MDBs. The IFC, AsDB and IADB generally adopt A:B ratios of between 1:4 and 1:2, whilst the EBRD generally adopts a ratio of 1:2, except in its most advanced countries where the ratio is occasionally 1:3. These ratios leave the MDBs with a far higher percentage of the loan on their own balance sheets than would be the common practice for the lead lender in the commercial syndicated loan market. The main drivers for setting the A:B ratio are:

- the importance that the MDBs are seen by their countries of operations to be prominent providers of funds in the loans for which they are lender of record; and
- the degree to which B lenders are satisfied that the MDB is holding a meaningful A loan for its own account, as the B lenders derive substantial comfort from the knowledge that the MDB is taking a significant portion of the loan on its own book.

Through the participation agreement, B lenders share in all of the risks of the loan agreement, both commercial and political. However, certain political risks are mitigated by the MDB's preferred creditor status, e.g.

- the convertibility of local currency to hard currencies; and
- the subsequent ability to transfer the hard currency out of the borrower's host country.

These mitigating factors, as well as the relationship of the MDB with the host government, the fact that each government is a member and shareholder of the MDB and has agreed to operate under the MDB's articles, combined with the long-term commitment of the MDB to the host country, constitute what is together known as the umbrella of the MDBs.

In addition to the umbrella described above, MDB loans are also exempt from certain taxes, including withholding taxes on principal or interest payments. Accordingly, B loans also enjoy this exemption.

2. PREFERRED CREDITOR STATUS AND POLITICAL RISKS

As has been stated above, the preferred creditor status of MDBs strongly mitigates political risks. The essence of this mitigation lies in the undertaking by the government of a project's host country (regardless of whether such project is private or public sector), that convertibility and transferability of currency will be assured in the event of a foreign exchange shortage at the national level.

Thus, although the B loan structure does not enhance the creditworthiness of the borrower *per se*, the structure essentially removes the key political risks associated with lending to private sector projects in emerging markets.

Hitherto, experience has shown that the MDBs' status as preferred creditors results in governments making foreign exchange available to private sector borrowers (to the extent that these borrowers themselves have adequate local currency) for servicing loans from MDBs while potentially withholding foreign exchange from the same borrowers for servicing loans from other lenders; and that governments have provided that foreign exchange even while defaulting on their own sovereign foreign currency obligations.

Carefully drafted documentation ensures, through pro rata sharing provisions, that both A and B loans receive identical treatment, so that there is no way to default on a B loan without simultaneously also defaulting on the A loan. Thus a government must accord preferred creditor status to both A loan and B loan, and cannot choose to accord it to one portion alone. Through this mechanism, the MDB's preferred access to foreign exchange is passed on to any non-preferred lenders that are under the MDB's umbrella.

The historical record of B loans being accorded preferred creditor status has been extremely good. To date, no EBRD B loans have been included in a general rescheduling of a country's debts, nor has the EBRD, or any of the lenders in its B loans been asked to put up any new money in the context of a general country debt rescheduling.

The MDBs take several factors into account when extending loans to projects in their member countries. Amongst these are:

- the historical and expected future treatment of preferred creditor institutions by the government of the country in which the brorrower is based;
- whether the current political regime has good relations with MDBs and is integrated into the global trade and financial systems; and
- whether debt to preferred creditor institutions is an unmanageably high percentage of external debt. In this regard, the MDBs continuously monitor their exposure levels in individual countries and in aggregate.

3. REGULATORY TREATMENT OF B LOANS

3.1 HISTORICAL TREATMENT OF B LOANS

The majority of commercial lenders have historically been required by their regulatory authorities to make statutory country risk provisioning (in varying degrees) for their cross-border medium-to-long term loan exposure to most emerging market countries. These provisioning requirements would normally prevent any commercial bank from making commercially viable loans to projects in most emerging countries.

However, through sharing in the preferred creditor status of MDBs by way of the A/B loan structure, most bank regulators allow the banks under their jurisdiction to enjoy exemption from country risk provisioning. Many leading bank supervisory authorities/regulators have recognised that the umbrella afforded by the MDB B loan was such that the country risks associated with lending to a project were effectively mitigated.

Accordingly, many regulators have acknowledged, either in writing or less formal guidelines, that banks under their regulatory authority which participate in MDB B loans, will be exempt from the statutory country risk provisioning which loans to certain emerging markets countries would otherwise attract. In many of those regulatory environments where statutory country risk provisioning was not the standard, regulators or auditors have generally also followed a favourable policy of exemption for B loans, where they would not otherwise have done so if these loans were not under an MDB umbrella.

This practice of exemption from statutory country risk provisioning has been an underpinning attraction for banks to invest in B loans.

3.2 CURRENT/FUTURE TREATMENT OF B LOANS

Based on the current proposals, all else being equal, it is expected that banks applying the new standard approach will at least continue to risk-weight these loans at 100% and to benefit from the favourable approach to MDB B loans currently offered with regard to country risk provisioning. Furthermore, based on the EBRD's experience to date, a case can be made for a lower risk weighting.

As detailed further in section 4 below, even significant portfolio shocks have led to write-offs of less than 3%, and the putative write-off experience for B loans is even lower, at 1.2% of total cumulative B loans.[11] Considering that our B loans typically have an average maturity of less than 8 years, if EBRD's write-off experience is

[11] Putative, because the EBRD is not privy to the write-off policy of the commercial banks who are its B lenders.

compared to historical default rates as reported by Moody's and S&P adjusted for an LGD of 50%, this falls within the range of single A to triple B rated experience. Based on the proposed weights for rated corporates, this implies a risk weighting of between 50% and 100%.

Banks that apply the internal ratings approach will need to consider how the B loan structure most appropriately fits into their own assessment of default probability. In this respect, it is likely that they will provide internal ratings that are commensurate with investment grade loans, or commercial loans for which they have purchased private political insurance. It is hoped that this note will provide information which will help the Committee to formulate appropriate language in the final Accord to guide banks, bank regulators and supervisors in assessing this aspect of internal credit risk models to ensure that accurate risk assessment is reflected in the capital adequacy framework.

4. WRITE-OFF EXPERIENCE[12]

The focus in this section will be on the EBRD's non-sovereign assets (i.e. private sector), as these are the assets which are syndicated in the form of B loans[13].

The EBRD normally writes off projects that have been fully provisioned for some time. The EBRD expects to write off impaired assets that have not been recovered over two to three years, on average. The timing of the write-offs is determined by the individual circumstances of the case.

During its history, the EBRD's portfolio has been impacted by several financial crises. The most recent and significant of these was undoubtedly the Russian financial crisis of August 1998. Indeed, it was during this crisis that the EBRD's preferred creditor status was first tested. The Russian authorities announced their moratorium on hard currency repayments on 17 August 1998, and by 19 August 1998 the Russian Central Bank had issued a decree exempting all payments due under loans from the EBRD and similar multilateral institutions, or from banks under the B loan umbrella. During the three-month moratorium all payments due to the EBRD and its B lenders came through in full and on time.

The EBRD has written off no sovereign assets and, prior to the Russian crisis, wrote off less than 1% of non-sovereign assets annually. Despite the Bank's very high concentration of exposure to Russia (20% of disbursements at the end of 2000), the EBRD wrote off less than 2.5% of outstanding non-sovereign assets at the end of 2000, and this was primarily due to the Russia crisis. Based on current projections it is expected that this level of write-offs will not be exceeded in the future.

The following chart shows the EBRD's historical write-off experience over the last four years. It is important to note that this chart does not disaggregate the EBRD's debt and equity portfolios. Rather, it shows the annual write-offs on both debt and equity against the total debt and equity non-sovereign operating assets.

The write-offs on debt would tend to be lower than on equity, and it is only debt that is syndicated in the form of B loans. Further, as it is generally the more attractive assets which are syndicated, it follows that the putative write-off rate would generally be lower on those B loans for which there has been a write-off on a corresponding EBRD A loan, than in the chart below.

[12] As of 31.12.2000.

[13] There is no policy which prevents sovereign assets from being syndicated in the form of B loans. It is not, however, currently envisaged that syndication of sovereign assets will be initiated in a significant volume in the near future.

EBRD historical non-sovereign write off experience[14]

	Annual write offs (€ millions)	Non-sovereign operating assets (€ millions)	Annual write offs as percentage of non-sovereign operating assets
1997	11	2,997	0.48%
1998	38	4,013	0.95%
1999	14	4,716	0.30%
2000	131	5,262	2.49%

Of the total cumulative amount of EBRD B loans that have been syndicated, amounting to € 2,500 million, the amount of B loans for which the corresponding EBRD A loan has been written off, amounts to approximately € 30 million, or 1.2% of total cumulative B loans.

The EBRD has experienced no write-offs on any of its loans as a direct result of political risks[15] (although political factors have played a part in bringing about the commercial failure of some projects).

[14] No sovereign assets have been written off.

[15] Political risks include the risks normally covered by export credit agencies or political risk insurers, i.e. convertibility and transfer risk, breach of contract (by government or quasi-governmental bodies), expropriation, war and civil unrest.

5. CONCLUSION

The MDBs are specialised financial institutions, with strong expertise in assessing both country risk and project risk in emerging markets. The EBRD's own write-off rate demonstrates a strong credit culture, reflecting its in-depth knowledge of the markets in which it operates.

The EBRD's own mandate includes that of mobilising funds from the private sector, and to date it has been successful in this respect. A part of that success lies in the recognition of bank regulators of the strength of the inherent risk mitigation that derives from investing in B loans.

The continued success of the MDBs to mobilise funds from the private sector relies on the regulatory community providing the appropriate guidelines to the commercial banks under their supervision.

It is our view that the appropriate guidelines for the banks should include the following minimum recommendations:

- that the Committee assign a standard method risk-weighting for so-called MDB B loans;
- that the Committee assign a weighting of less than 100% for MDB B loans in the standard approach;
- that the Committee mention in the final Accord that, as has been the practice to date, country risk provisioning is not required for MDB B loans; and
- the Accord state that for internal models, the implicit political risk umbrella provided by MDBs should be treated at least as favourably as explicit political risk guarantees provided by high quality insurance providers.

How Preferred Creditor Support Enhances Ratings

The Latin American financial market turmoil in 1994-1995 and the more widespread turbulence since 1997 have prompted efforts to devise new structures to enable transactions originating in emerging market countries to achieve foreign currency ratings higher than those of their sovereigns. One approach, "future flow structured transactions," uses structural, administrative, and legal features to accomplish this goal. A second approach, preferred creditor transactions, uses the preferential treatment afforded some multilateral lending institutions to do the same.

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Standard & Poor's has rated six preferred creditor transactions, from four different countries: the United Mexican States (local currency rating BBB+/Stable/A-2, foreign currency rating BB/Stable/B); the Republic of Argentina (local currency rating BBB-/Stable/A-3, foreign currency rating BB/Stable/B); the Federative Republic of Brazil (local currency rating BB-/Negative/B, foreign currency rating B+/Negative/B); and the Kingdom of Thailand (local currency rating A-/Stable/A-2, foreign currency rating BBB-/Stable/A-3). These transactions have generally performed well since being rated, with only one having been downgraded, and that by a singe notch.

Nonetheless, there have been developments that dictate a more critical approach to these transactions. Moreover, careful consideration of the country of domicile of the issuer and the preferred creditor institution supporting the transaction is essential and requires that ratings be done on a case-by-case basis.

Preferred Creditor Institutions

Sovereign governments are unique in the latitude that they have to decide which obligations they will pay, or permit to be paid, and which they will not. During the postwar era, governments have generally taken the view that obligations to some multilateral lending institutions, including the International Bank for Reconstruction and Development (World Bank), the Inter-American Development Bank (IADB), the Asian Development Bank, the African Development Bank, the International Finance Corp. (IFC), the European Bank for Reconstruction and Development (EBRD), and the Corporacion Andina de Fomento (CAF), warrant payment even when countries are defaulting on their sovereign obligations to other lenders. Moreover, the countries of the Paris Club have agreed with this view and exempted these institutions—"preferred creditor institutions"—from application of the comparability-of-treatment principle. While most of these institutions have experienced payment delays caused by government actions—some lasting several years—these delays have typically been fewer and shorter than those experienced by commercial and official bilateral lenders. Moreover, these institutions have not been required to participate in general reschedulings of countries' external debt.

Preferred creditor status is fundamentally a political expression and is de facto, as a matter of conduct, rather than de jure, as a matter of law. This conduct, in turn, reflects sovereigns' incentives to place priority on loan repayments to multilateral lending institutions. These incentives include committed loans that have yet to be disbursed, the willingness to initiate new loans when other lenders will not, the availability of generally lower-cost funds at longer-term maturities, technical assistance, and the threat of sanctions; they are reinforced by the almost universal policy among multilateral lenders of not participating in loan reschedulings. Buttressed by the long record of favorable treatment of loans from multilateral institutions by sovereigns under severe financial distress, these incentives have led Standard & Poor's to expect that in most cases obligations to these institutions will receive similarly preferential treatment in the future.

To date, Standard & Poor's has rated preferred creditor transactions of the IFC, the World Bank, and the IADB. Transactions involving other institutions claiming preferred creditor status are under discussion. However, the claims of preferred creditor status by these institutions, and the transactions themselves, will be considered on a case-by-case basis.

Preferred Creditor Transactions

Certain structures permit preferred creditor treatment to be passed on to other lenders, and their use may allow transactions to be rated higher than the applicable sovereign foreign currency rating. However, the fact that a preferred creditor institution is involved in a transaction does not by itself make it a preferred creditor transaction. Keeping in mind that a Standard & Poor's credit rating is an opinion on the likelihood of full and timely payment of a financial obligation, a preferred creditor transaction:

- Relies on the sovereign's preferred creditor treatment of an institution to enhance the probability that foreign exchange will be available for the full and timely payment of interest and principal by the emerging market borrower to third-party lenders. If the payment to third-party lenders does not rely on preferred creditor treatment, the transaction is strictly speaking not a preferred creditor transaction. For instance, the World Bank, the IFC, and the IADB are all rated 'AAA' by Standard & Poor's, and any transaction unconditionally guaranteed by these institutions would be assigned an 'AAA' rating. However, in providing a guarantee, they would be indistinguishable from the point of view of third-party lenders from any other 'AAA' rated financial institution—their status as preferred creditor institutions, while no doubt enhancing the performance of their loan portfolios and thereby contributing to their own 'AAA' ratings, would contribute nothing to the rating of the transaction which they are guaranteeing. As a consequence, a fully guaranteed transaction is not a preferred creditor transaction.
- Is structured so that a borrower satisfying all of its obligation to the preferred creditor will satisfy all of its obligations to third-party lenders. For instance, in 1990 the World Bank guaranteed the principal, but not the interest, on a 10-year bullet bond issued by the Republic of Hungary (local currency rating A/Stable/A-1, foreign currency rating BBB/Positive/A-3). While this guarantee had real economic value and thus provided comfort to investors and enhanced the marketability of the bond, it would not have enhanced the rating (Hungary was not rated by Standard & Poor's until 1992). This is because the interest payments remained the responsibility of the government of Hungary, and as long as the government could default on a payment of interest *or* principal without defaulting on its obligation to the World Bank, the bond would have received Hungary's sovereign foreign currency rating. By contrast, in 1998 the World Bank enhanced its partial credit guarantee program by including—in addition to a guarantee of US$300 million of principal—a "rolling" interest guarantee whereby the World Bank undertook to make one interest payment on behalf of the issuer, the Electricity Generating Authority of Thailand (EGAT), should

EGAT not make the payment itself. If the World Bank made such an interest payment and were reimbursed by EGAT or the government of Thailand (which provided an indemnity to the World Bank) within 60 days, the interest guarantee would be reinstated and again cover one interest payment; if it were not reimbursed, the interest guarantee would not be reinstated. This transaction was rated three notches above the sovereign foreign currency rating of Thailand. It was not the World Bank's guarantee of one additional interest payment itself that justified the upgrade—since subsequent interest payments were not similarly guaranteed—but rather the expectation that the government of Thailand would make that payment to the World Bank within the grace period even if it defaulted on other sovereign obligations. As a corollary, should the World Bank make an interest payment to EGAT's bondholders and not be reimbursed by EGAT or the government of Thailand within 60 days, the transaction would immediately be downgraded to the current rating of the Kingdom.

Criteria for Sovereign Guaranteed or Indemnified Preferred Creditor Transactions

While Standard & Poor's factors preferred creditor status into its ratings of both sovereign and private-sector issues, it does so using different criteria.

For preferred creditor transactions guaranteed or indemnified by a sovereign borrower, Standard & Poor's is prepared to assign a foreign currency rating as much as three notches above the sovereign foreign currency issuer credit rating if:

- The government has not defaulted on any obligations to any multilateral with preferred creditor status under the auspices of the current regime, or if so, not within the preceding 15 years. If recent or anticipated political changes suggest possible diminution of the priority accorded to preferred creditor debt, the rating enhancement may be fewer than three notches, even with an unblemished payment record.
- The political regime has good relations with multilateral institutions and is integrated into global trade and financial systems. If the political system is less than fully open, or if some local interest groups advocate a more isolationist path, the rating enhancement may be fewer than three notches.
- Preferred creditor debt and debt service are a fairly modest portion of total external obligations. The higher the proportion of preferred creditor status debt and debt service, the lower the ability of the sovereign to accord it priority. If the proportions of preferred creditor debt and debt service are low, but Standard & Poor's believes that there is a significant probability that they will rise appreciably over the term of the issue, the rating enhancement may be fewer than three notches.

The EGAT example cited above was Standard & Poor's first rating of a World Bank preferred creditor transaction. Since Thailand satisfied all of the three conditions outlined above, the transaction was rated 'A-', three notches above Standard & Poor's 'BBB-' sovereign foreign currency rating of the Kingdom.

It is important to note that since a sovereign guaranteed or indemnified preferred creditor transaction can be rated a maximum of three notches over the sovereign foreign currency rating, if Thailand's sovereign foreign currency rating were to be reduced, the rating of the EGAT transaction would be reduced pari passu. While this is not necessarily the case of a transaction enjoying a lower notch rating enhancement, it is likely unless there is some offsetting positive change.

Criteria for Unguaranteed and Private-Sector Preferred Creditor Transactions

All of the borrowers for IFC and IADB transactions rated by Standard & Poor's have been private-sector entities. In each case, one of these multilateral institutions has been the "lender of record"—the direct lender to the borrower. It in turn has maintained a portion of the loan on its balance sheet (the "A" loan) while participating a

portion of the loan out to commercial bank and/or institutional lenders (the "B" loan). These participations are either directly to the banks and institutional lenders or through securitizations of the loans through the use of special-purpose vehicles (SPVs). In either case, the participants bear the full commercial risk of the borrower—the credit enhancement of the transaction comes from the expectation that during a time of financial distress, the authorities will provide borrowers the opportunity to purchase foreign exchange to service loans to these institutions while denying or delaying that opportunity for loans by other creditors.

In these transactions, the rating analysis begins with the local currency rating of the borrower, which reflects the borrower's willingness and ability to service all of its obligations, regardless of currency, absent foreign exchange controls. If the borrower's obligation is to the IFC or the IADB, which have been determined by Standard & Poor's to be preferred creditor institutions in this context, Standard & Poor's expectation is that foreign exchange will be made available by the monetary authorities to the borrower against payment of the corresponding local currency to service its obligation. Accordingly, the constraint of the sovereign foreign currency rating is effectively removed, and the borrower's obligation can be assigned a foreign currency rating equal to its local currency rating. As in the case of the sovereign guaranteed preferred creditor transactions, however, this higher rating is subject to the past record of the borrower's country with respect to payment of multilateral obligations, the quality of its relations with multilateral institutions and its integration into the global trade and financial systems, and the relative size of the country's preferred creditor debt and debt service. It is thus possible for a transaction in a country not meeting these criteria to receive a foreign currency rating lower than its local currency rating, but still above the sovereign foreign currency rating.

The first preferred creditor transaction rated by Standard & Poor's employing these criteria was that done in 1995 for Apasco, a Mexican-domiciled cement company. The company's local currency rating was 'BBB+'; and Mexico's sovereign foreign currency rating was 'BB'. The IFC's US$85 million B loan to Apasco was placed in an SPV, the only asset of which was the IFC's B loan. The US$85 million notes issued in turn were rated 'BBB+' by Standard & Poor's, equal to the local currency rating of Apasco. Since that time, Standard & Poor's has rated similar IFC transactions originating in Mexico, Argentina, and Brazil. In each case, they have been assigned a foreign currency rating equal to the company's local currency rating. In a rating of a direct participation, earlier this year Standard & Poor's assigned its first rating to a B loan from the IADB to Transportadora de Gas del Sur S.A. (TGS), Argentina's largest natural gas transportation company. While Argentina's sovereign foreign currency rating was 'BB', the IADB's loan to TGS was rated 'BBB-', equal to the local currency rating of the company.

It is important to note that under these criteria, and unlike the ratings of sovereign guaranteed transactions, the ratings of unguaranteed transactions are in principle independent of the sovereign foreign currency rating. Accordingly, there is no presumption that a reduction in the sovereign foreign currency rating will be accompanied by a reduction in the rating of the transaction. Of course, such a reduction could happen if there were a concomitant

Table 1

Loan Portfolio Characteristics of Select Multilateral Lenders

[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	10,220	[illegible]
Asian Development Bank	24,698	10,993	[illegible]
African Development Bank	9,026	927	2.2
International Finance Corp.	5,898¶	1,764	7.4
European Bank for Reconstruction and Development	4,545	376	64.6
Corporacion Andina de Fomento	3,547	2,092	19.5

*Source: "Supranationals," September 1998, Standard & Poor's. *End-June 1993 to end-June 1998 for World Bank and IFC. ¶End-June 1998.*

reduction in the rating of the issuer, which can happen for reasons that also occasion the downgrade of a sovereign foreign currency rating, or if developments raised concern about future respect for the multilateral institution's preferred creditor status.

PREFERRED CREDITOR TRANSACTIONS GROW IN POPULARITY

Disbursed loans of multilateral institutions have increased at a relatively modest rate in recent years. For instance, between year-end 1993 and 1998, disbursed loans of seven rated multilateral lenders to emerging market countries increased at an average annual rate of 4.0%. In absolute terms, the Asian Development Bank and the IADB were leaders, with the EBRD a distant third. In percentage terms, the increase was paced by the EBRD, which started from a very low base, with CAF and the Asian Development Bank showing lower, but still double-digit, growth.

By contrast, the aggregate value of preferred creditor loan participations has increased sharply, albeit from a low base. This increase has been almost entirely the result of the IFC's loan participation program, which increased the value of participations (outstanding plus undisbursed) to US$9.2 billion at end-June 1998 from US$2.8 billion at end-June 1993, an average annual increase of 27.2%. The IADB has also become more active in this area, albeit from a very low base. At year-end 1996, the IADB had US$73 million in participated loans, which increased to US$231 million at year-end 1997 and US$256 million at year-end 1998. A substantial increase is expected during 1999, with a single B loan participation of US$176 million for TGS already having been rated and placed with investors. In addition, the World Bank's EGAT transaction added US$300 million in preferred creditor debt. Standard & Poor's has been shown transactions involving other multilateral institutions, and it seems likely there will be preferred creditor transactions emanating from additional multilaterals so long as there is market appetite and sovereigns continue to accord preferred creditor status.

New structures employing preferred creditor status have been developed. The IFC has again been the leader in this regard, with two notable transactions: the 1994 securitization of US$400 million of its A loan portfolio; and the "single-asset securitizations," such as that for Apasco noted above. These were important transactions because they were the first rated preferred creditor transactions; they brought the advantages of preferred creditor status to the attention of institutional investors; they were placed with institutional investors rather than the IFC's usual bank participants, which facilitated an expansion of the IFC's B loan program; they permitted longer maturities than were generally available from banks; and in the case of the single-asset securitizations, they allowed individual borrowers to be introduced to the capital markets. In addition, as described above, the World Bank's EGAT transaction was a potentially important innovation. Finally, Standard & Poor's has been shown other structures utilizing multilaterals' preferred creditor status, some of which may be viable should the sovereigns and the institutions agree to support them.

ISSUES REGARDING PREFERRED CREDITOR TRANSACTIONS

Preferred creditor transactions have become attractive to a growing number of market participants, both banks and increasingly, institutional investors. However, Standard & Poor's has concerns regarding these transactions of which investors and the originating institutions themselves should be aware. These concerns include the following:

- Will the preferred creditor status of multilateral institutions continue to be respected by sovereigns? As noted above, the ratings enhancement given preferred creditor institutions depends on sovereign governments continuing to accord preferred creditor status. Should that preference diminish even among a limited number of countries, higher ratings on transactions involving preferred creditors would be difficult to sustain. It was thus of some concern when the Islamic Republic of Pakistan ('SD'—selective default) failed to permit commercially viable IFC loans to be serviced in a timely manner during the second half of 1998.

However, eventually the foreign exchange was made available, reinforcing the IFC's preferred creditor status vis-à-vis Pakistan.

- Will the extension of preferred creditor status to private-sector lenders continue to be permitted by the major industrial countries? One result of the global financial turbulence of recent years has been the reconsideration of the existing "international financial architecture." One harbinger of change is the decision of official bilateral creditors, working through the Paris Club, to require the government of Pakistan to seek rescheduling of its bonds under the principle of "comparability of treatment." There have also been proposals that bond documentation be amended to facilitate the "bailing in" of private-sector lenders. Under these circumstances, it is at least plausible that at some point the major industrial countries—which are also the principal shareholders of the multilateral institutions—may become unwilling to allow private-sector lenders to fully enjoy the benefits of preferred creditor status and may decide to "bail in" those lenders as well. Depending on how this policy change would be applied, it could result in an immediate reduction in the ratings of all preferred creditor transactions. In this regard, it is important that preferred creditor institutions be seen as filling a special niche among lenders. This includes supporting transactions consistent with their role as development institutions, successfully mobilizing private-sector capital to support their transactions, and more generally, acting as a catalyst for other development-supporting transactions.
- Does concentration of preferred creditor risk make preferential treatment of preferred creditor transactions untenable? At the limit, if all of a country's external debt is accorded preferred creditor status, then effectively none of it is. Most emerging market countries have loans from at least three rated multilateral institutions, and some Latin American countries have loans from four (the World Bank, the IFC, the IADB, and CAF). In addition, there are other unrated multilateral institutions claiming preferred creditor status. Accordingly, while it is possible that no single institution would account for an unsettling portion of a country's medi-

Table 2

Select External Debt Ratios to Multilateral Lenders

[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
Paraguay	[illegible]	[illegible]	[illegible]
Pakistan	[illegible]	[illegible]	[illegible]
Costa Rica	44.9	[illegible]	[illegible]
Papua New Guinea	38.7	13.5	22.0
Trinidad & Tobago	36.9	26.3	13.8
India	33.1	[illegible]	[illegible]
Romania	32.4	(22.1)	19.0
Morocco	31.7	6.4	34.9
Dominican Republic	27.9	5.0	30.8
Kazakhstan	24.1	24.1	9.5
Philippines	22.3	(3.6)	28.0
Jordan	20.8	7.8	33.8
Peru	18.6	5.4	20.6
Indonesia	16.3	(7.2)	14.8
Mexico	14.7	(4.3)	7.5
Panama	14.3	(4.1)	7.5
Bulgaria	13.1	10.1	32.6
Lebanon	11.4	(4.5)	5.0
Argentina	10.3	0.2	6.9
Slovak Republic	9.3	(4.4)	5.5
Turkey	9.8	(12.1)	16.1
Korea	8.8	(1.5)	5.4
Venezuela	8.4	(0.8)	5.9
Brazil	6.4	(3.3)	5.5
Russia	5.0	4.1	4.6
South Africa	0.0	0.0	0.0

Source: World Bank.

um- and long-term external debt—since that is what is generally rescheduled—it is possible that collectively multilateral institutions could. World Bank data on external debt provide some rough but nonetheless helpful figures in this regard. Table 2 shows for selected countries, as of year-end 1997, public and publicly guaranteed debt to multilateral institutions as a percentage of total medium- and long-term external debt, and debt service on multilateral debt as a percentage of total external debt. In addition, it shows the change in the ratio of multilateral to total external debt between year-end 1992 and 1997. Since no IFC loans are government guaranteed, and since the IADB and CAF are now doing a limited amount of lending to private-sector borrowers without government guarantees, these numbers underestimate the total share of preferred creditor debt. Nonetheless, they are helpful in identifying which countries are less likely to be given the full ratings enhancement for preferred creditor transactions because of the share of preferred creditor debt and its rapid growth. As shown in the table, for three countries—the Republic of El Salvador (local currency rating BBB+/Stable/A-2, foreign currency rating BB+/Stable/B), the Republic of Bolivia (local currency rating BB+/Stable/B, foreign currency rating BB-/Stable/B), and the Republic of Paraguay (local currency rating BB+/Negative/B, foreign currency B+/Negative/B)—preferred creditor debt accounts for more than half of total medium- and long-term external debt; and for two other countries, Pakistan and the Republic of Costa Rica (local currency rating BB+/Stable/B, foreign currency rating BB/Stable/B), multilateral debt is more than 40% of total external debt. Moreover, in four of these five cases, there has been a significant increase in the share of preferred creditor debt between 1993 and 1998. On the other hand, Brazil, Argentina, and Mexico have relatively low shares of multilateral debt, and thus far the amounts of unguaranteed preferred creditor debt are relatively modest.

- Is the transaction excessively "stretching the umbrella"? In addition to the transaction being structured so that by meeting its obligations to the preferred creditor institution the borrower fully services all of its obligations under the transaction, Standard & Poor's requires that the preferred creditor institution retain a meaningful stake in the transaction. Accordingly, Standard & Poor's would not grant—or continue to grant—full preferred creditor status to a transaction that was completely removed from the books of the preferred creditor institution, either by participating out all of a loan on an individual basis (a B loan participation or securitization) or by including all of an A loan in a pool of securitized loans of which it did not retain a meaningful share. This is important, since Standard & Poor's has been shown structures in which the preferred creditor institution was only involved as a booking agent to accord the transaction preferred creditor status.

Summary

In according preferred creditor status, sovereigns effectively allow for enhanced ratings of foreign currency transactions. Additional transactions of this type seem likely. However, each of these transactions must be rated on a case-by-case basis. Moreover, some ratings may be affected by changes in the sovereign rating (sovereign guaranteed or indemnified transactions), while others will be affected by changes in the underlying creditworthiness of the borrower (unguaranteed or private-sector transactions). Finally, all ratings of preferred creditor transactions are ultimately reliant on the multilateral lenders continuing to enjoy preferential treatment from the countries into which they are lending, which may be less certain today than seemed the case a few years ago because of the growth of preferred creditor debt to high levels in some countries and the possibility that Paris Club countries will decide to impose comparability of treatment on participants in preferred creditor loans. CW

BEHIND THE RATINGS

"B" Loans and Political Risk Insurance: Different Roads to the Same Destination

Under these structures, the multilateral institution makes a loan to a private-sector borrower in an emerging market country...

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Lenders taking foreign currency credit exposure to private-sector issuers in emerging market countries have long been concerned that foreign exchange controls might prevent these issuers from servicing their obligations. Two means of mitigating this risk—participations in loans made by select multilateral institutions (so-called "B" loans) and "political risk insurance" (or, more specifically, transfer and convertibility (T&C) insurance)—have become more prominent since both were tailored to meet the requirements of the capital markets (see "How Preferred Creditor Support Enhances Ratings," *CreditWeek*, June 30, 1999, also published on RatingsDirect, and at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns; and "Political Risk Insurance May Enhance Emerging Market Structured Transactions," *CreditWeek*, Dec. 1, 1999, also published on RatingsDirect, and at www.standardandpoors.com under ResourceCenter-RatingsCriteria-StructuredFinance in Securitization in Latin America 2000).

Neither the "B" loan structure nor T&C insurance enhances the underlying creditworthiness of an issuer; consequently, neither elevates the local currency rating of the obligor. However, both can mitigate transfer and convertibility risk, allowing an obligation to receive a foreign currency rating as high as the issuer's local currency rating.

"B" LOANS AND T&C INSURANCE

Both means of mitigating sovereign risk are well established. The International Finance Corp. (IFC), the pioneer in developing the "B" loan structure, was making "B" loans in the 1970s, and the Inter-American Development Bank, the European Bank for Reconstruction and Development, and the Asian Development Bank have more recently established their own "B" loan programs. Under these structures, the multilateral institution makes a loan to a private-sector borrower in an emerging market country, thereby becoming the "lender of record," that is, the sole contractual lender on the books of the borrower, with this status acknowledged by the government of the borrower's country. However, instead of maintaining all of the loan on its own books, the multilateral maintains only a portion—the "A" loan—and participates the remainder—the "B" loan—to commercial banks and/or institutional lenders, either directly or through a securitization.

Multilateral lending institutions have historically enjoyed treatment as so-called "preferred creditors." As such, not only have governments made foreign exchange available to private-sector issuers (with sufficient local currency) for servicing loans from these institutions while withholding it from these same issuers for servicing loans from other lenders; but they have provided that foreign exchange even while defaulting on their own foreign currency obligations. Carefully drafted documentation ensures,

through pro rata sharing provisions, that both "A" and "B" loans receive identical treatment, so that there is no way to default on a "B" loan without also defaulting on an "A" loan. Therefore, if a government is to accord preferred creditor treatment to the multilateral lender's "A" loan, it must also do so to each participant's "B" loan, in effect passing on the preferred access to foreign exchange to nonpreferred creditor lenders (placing them "under the umbrella" of the multilateral lender).

The first rated securitization of a "B" loan was done in 1995 by the IFC for Apasco, a Mexican cement company. The $85 million portion of the IFC's $100 million loan that was securitized received a foreign currency rating of 'BBB+', equal to Apasco's local currency rating and four notches above Mexico's 'BB' long-term foreign currency rating at the time. It was this transaction that brought the rating enhancement capabilities of the preferred creditor status of multilateral lenders to the attention of the capital markets.

Government-sponsored and some private insurers have been selling political risk insurance, including T&C insurance, for many years—the U.S. government's Overseas Private Investment Corp. (OPIC), for instance, has been underwriting political risk insurance since 1971. However, only in 1999 was the first rated capital markets transaction benefiting from T&C insurance (from OPIC) completed, this being the placement of $105 million of obligations of Otosan, the Ford-Koc Group joint venture automobile manufacturer domiciled in Turkey.

Standard & Poor's has rated numerous other "B" loan obligations. Last year, it rated the OPIC T&C-insured obligations of TGN, an Argentine gas pipeline company; a Multilateral Investment Guarantee Agency (MIGA, a member of the World Bank Group) T&C-insured pool of lease payments for medical equipment in Brazil; and an ACE Bermuda Insurance Ltd. T&C-insured sale of hydrocarbon royalty payments by the Argentine province of Salta. In all cases, the foreign currency ratings assigned were equal to the local currency sovereign credit ratings of the issuers, although this need not be the case. However, despite the equivalent ratings enhancement provided by "B" loan structures and T&C insurance to date, there are fundamental and important differences between them.

"B" loan enhancement stems from incentives for the government to provide the necessary foreign exchange; T&C insurance enhancement stems from the prospect of continued payment of debt service when a covered event of interference actually occurs. The first distinction, critically important to those taking a strictly legal perspective, is the difference in the manner in which "B" loans and T&C insurance provide their sovereign risk mitigation. The country risk mitigation of the "B" loan structure depends completely upon the willingness and ability of a borrower's government to accord preferred creditor treatment in a time of severe financial stress and to provide foreign exchange so that loans made and participated by multilaterals may be serviced. If the government is unwilling or unable to do so, holders of "B" loans have no recourse to the multilateral lender or any third party. In such a situation, of course, the multilaterals, in addition to suffering the nonpayment of their "A" loans, also experience damage to their preferred creditor status. As a consequence, these institutions work diligently to ensure that foreign exchange is made available. For instance, the IFC, through its own operations and with the support of the World Bank, brings pressure on the borrower's government to meet its obligations. Nonetheless, had there been "B" loans to Iraqi borrowers outstanding in 1990, it is unlikely that participants would have benefited, since Iraq would in all likelihood have ceased to accord preferred creditor treatment to IFC following the invasion of Kuwait and the sanctions that were subsequently imposed, as it did to the World Bank.

It is also possible that a country otherwise disposed to respect preferred creditor status may find its foreign exchange position sufficiently dire that it makes the political decision not to meet its obligations to multilaterals, including the obligation to provide foreign exchange to private-sector bor-

In rating the "B" loan obligations created by IFC, Standard & Poor's looked closely at the historical record of treatment of obligations to the IFC, which has been very good.

rowers with sufficient local currency to purchase foreign exchange at a rate reflective of severe financial stress. This appears to have been the case of Pakistan in 1998. While the government explicitly acknowledged IFC's preferred creditor status, it argued that it simply did not have the foreign exchange to provide to borrowers from the IFC. Once negotiations for a new loan from the World Bank were completed in early 1999 the foreign exchange situation eased, and foreign exchange for the payment of all IFC obligations was quickly provided.

In rating the "B" loan obligations created by IFC, Standard & Poor's looked closely at the historical record of treatment of obligations to the IFC, which has been very good. To date, no IFC loan has been included in a general rescheduling of a country's debts, nor has IFC, or any participant in its loans, been requested to put up new money in the context of a general country debt rescheduling. Moreover, while there have been occasional sovereign-induced delays in servicing of IFC loans, these have ordinarily been short.

Standard & Poor's recognizes that there could be failures to accord preferred creditor treatment, and, as a consequence, always explicitly considers three factors in rating these transactions:

- The historical and expected future treatment of preferred creditor institutions by the government of the country of domicile of the borrower,
- Whether the current political regime has good relations with multilateral institutions and is integrated into the global trade and financial systems,
- Whether debt to preferred creditor institutions—along with debt from structured finance transactions, which also may claim the most senior status—is an uncomfortably large percentage of external debt. In this regard, the multilaterals have generally demonstrated prudence in managing their preferred creditor exposure levels in individual countries and in aggregate.

By contrast, claims payments from a T&C insurance policy are made following an event of sovereign interference with the conversion of local currency to foreign currency or the transfer of that foreign currency abroad. As long as the terms of the policy are satisfied, payment depends entirely upon the willingness and ability of the T&C provider to pay claims in a timely manner and is not contingent upon the behavior of the government of the issuer. Thus, in the examples of both Iraq and Pakistan, assuming that the requirements of the policy and the claims process were satisfied and that the insurer was willing and able to meet its obligations, lenders would have received debt service payments in a timely manner up to the limit of the policy.

"B" loan enhancement covers all debt service and related payments; T&C insurance may only cover a portion. By virtue of its lender-of-record status and the associated loan and participation agreements, all debt service and other transaction-related payments are typically made directly to the multilateral lender, including all payments destined for "B" loan participants. Accordingly, all payments including principal, interest, fees, and penalties enjoy the benefit of the institution's preferred creditor status.

By contrast, what payments and how much of these payments are covered by T&C insurance depends upon the terms of the policy, which can vary substantially from transaction to transaction. For instance, on the Otosan transaction mentioned above, OPIC insured 100% of principal and interest on the rated securities. However, in some subsequent transactions, insurance applicable to only a portion of total debt service has been proposed. Standard & Poor's criteria now permit the rating of a foreign currency obligation to be elevated, sometimes as high as the local currency rating of the obligor, even when the insurance covers less than 100% of interest and principal (see "New Rating Approach Gives Private-Sector Issuers Credit for Partial Coverage of T&C Risk," *CreditWeek*, Nov. 2, 2000, also published on RatingsDirect, and at www.standardandpoors.com under ResourceCenter-RatingsCriteria-Sovereigns). The degree of elevation will depend upon the country of domicile of the issuer, how much T&C insurance is provided relative to the debt service payments, the pattern of debt ser-

vice payments, the expected timing and duration of any sovereign interference, and the rating of the insurance provider.

Multilateral lenders are invariably concerned about the commercial success of the borrower; nonmultilateral insurers have little cause for concern. While "B" loans may not enhance the underlying creditworthiness of an issuer, multilateral lenders have a different relationship with borrowers than do most insurers, particularly private-sector insurers, which some "B" loan participants value highly. A multilateral lender is invariably concerned with the commercial viability of the borrowers under its "B" loan program. Not only is the multilateral always a lender, and typically the largest single lender; but it also structures the transaction, negotiates the credit agreement with the borrower, and conducts the due diligence. As "B" loans become increasingly important to the multilaterals—and IFC's "B" loans, for instance, were larger than its own loan portfolio at end-June 1997 and 1998, although lower than that during the past two years—it is increasingly important for them to build and maintain strong relationships with participants, which are damaged when there are problems with timely repayment of "B" loans for commercial reasons.

More broadly, a multilateral has a long-term commitment to facilitate private-sector investment in the countries in which it operates. Should new government policies, a weakening regulatory environment, or a breach of government commitments imperil projects in which the multilateral is lending, a multilateral will use its influence with the government to overcome such problems. This can be an important factor in facilitating successful project implementation.

While multilateral providers of T&C insurance have similar broad concerns, other providers of T&C insurance have little at stake in the commercial viability of an issuer, since they lose nothing except premium income when an issuer defaults for commercial reasons. Their real concern is that the borrower's country of domicile not take action resulting in a claim under its T&C policy. Indeed, in a time of severe financial distress, when the probability of sovereign interference with payment of foreign currency obligations increases, the position of the insurer will actually be improved by the bankruptcy and liquidation of the borrower. This is because the insurer is not obligated to pay under its T&C policy if the borrower does not have local currency sufficient to purchase the foreign currency required to make its debt service payments.

If the issuer has the required local currency, the relevant willingness and ability to supply foreign exchange under a "B" loan is that of the borrower's government; with T&C insurance, it is that of the insurer. The issues of willingness and ability to pay are qualitatively different for multilaterals and T&C insurance providers. In the case of "B" loans, multilaterals act only as intermediaries and not as providers of formal insurance to the "B" loan participants. The issues of willingness and ability to make foreign exchange available in a timely fashion to borrowers with sufficient local currency relate entirely to the sovereign, whose decisions are made in light of the preferred creditor status of the multilateral.

By contrast, the willingness and ability of providers of T&C insurance to pay in a timely manner are key. Ability to pay is extremely strong in the case of OPIC—its obligations are backed by the full faith and credit of the U.S. government—and very strong for other bilateral official insurers from most highly rated countries or highly rated multilaterals. However, Standard & Poor's looks closely at not only the standalone financial strength of an official insurer, but also at the degree and manner of expected support from its government owners. The ability of a private insurer to pay claims is determined by its financial strength rating, and no transaction enhanced by T&C insurance from a private insurer will be rated without a rating of the insurer.

The ability to pay must be accompanied by the willingness to pay, and in a timely manner. The best evidence of willingness to pay is a long history of satisfactory claims-paying behavior, such as that of OPIC. Moreover, OPIC has tailored its

"B" loan structures ultimately rely upon the willingness and ability of the borrower's government to afford preferred creditor treatment to the multilateral providing the "B" loans...

claims processing procedures explicitly to address the issue of timeliness, and Standard & Poor's is comfortable that a valid claim will be processed and paid in a manner consistent with the rating of the insured transaction. The claims-paying behavior of other long-active insurers—mostly official—would be subject to a similar review, as would the tailoring of their claims processing procedures. The absence of a long claims-paying history would require in-depth discussions with the senior management of the insurer and, if appropriate, its parent.

Two aspects of willingness that must be considered are those of policy exclusions and the insurer's approach to handling claims. T&C insurance is not a guarantee of timely payment, and claims are payable only if the requirements of the policy and other documentation have been satisfied. For instance, in the case of the OPIC insurance policy, grounds for denying payment of a claim could be the lack of a satisfactory effort by the insured to use all reasonable efforts to convert local currency and transfer it, or a finding that an unreasonable act by the insured was the primary cause of the sovereign interference. Similarly, the "company support agreement" between OPIC and the borrower includes covenants relating to corrupt practices, environmental matters, and worker rights, violation of which are grounds for the denial of a claim or the cancellation of the policy. In general, covenants of this nature seem more likely to appear in policies of official rather than private insurers, since they reflect the policy concerns of the government sponsor.

The second aspect of willingness to pay concerns the way certain issues relating to claims payments are handled and has been highlighted by recent experience with some providers of financial guarantees. The policies of so-called "monoline insurers"—companies whose only business is providing financial guarantees—are standardized to meet the requirements of the rating agencies with respect to timeliness of payment and the approach to disputed claims. In short, they are expected to pay on time and to challenge the claim later. However, recently more "multiline" insurers have begun issuing financial guarantees. In some of these institutions, the culture is one of paying a claim only after a challenge to that claim has been adjudicated. For instance, in the case of suspicion of fraud, monoline insurers are expected to make the scheduled payment and then pursue remedies, whereas some multiline policies allow the insurer the right to review a claim prior to paying and refuse payment if it feels that the claim is invalid. As a consequence, Standard & Poor's has determined that in some cases the willingness of a multiline insurance company to pay on a timely basis may be considerably weaker than its ability to pay. In light of this, Standard & Poor's has developed "financial enhancement ratings," which explicitly address both ability and willingness to pay (see "Criteria for Insurer Financial Enhancement Ratings Introduced," *CreditWeek*, Aug. 2, 2000, also available on RatingsDirect). In all cases, a very close reading of all related documents and a clear understanding of exactly what is being insured are essential to the rating.

SUMMARY

While "B" loan structures and T&C insurance can both elevate the foreign currency credit ratings of obligations of private-sector borrowers from emerging market countries as high as the borrowers' local currency credit ratings, they do so in very different ways. "B" loan structures ultimately rely upon the willingness and ability of the borrower's government to afford preferred creditor treatment to the multilateral providing the "B" loans; T&C insurance relies upon the willingness and ability of the insurer to pay in accord with the terms of its policy in a timely manner once sovereign interference has actually occurred. Insurance may cover only a portion of debt service payments, while "B" loans, by their nature, cover all payments. Insurance also generally introduces more documentary complexity, which must be assessed to determine whether difficulties could arise that would affect the ability to successfully claim under the insurance policy. CW