

SOVEREIGN FINANCIAL GUARANTEES

by

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The purpose of sovereign guarantees

States issue financial guarantees in order to financially promote projects that are deemed to be in the public interest. The guarantees are used as economic incentives for the capital market to finance the projects. In Sweden, for example, financial guarantees have in the past been used to promote agriculture, fishing, housing construction, shipbuilding and energy supply. From the beginning of the 90's, they have primarily been used to alleviate the Swedish bank crisis and for promoting investment in the infrastructure.

Financial guarantees always involve risk

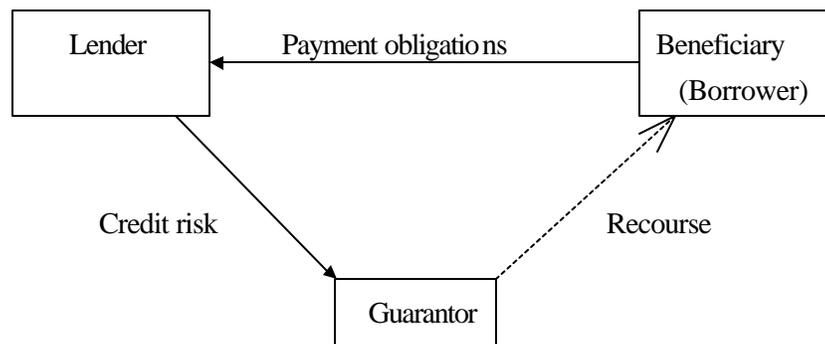
A *financial guarantee* may be described as an undertaking by the guarantor to pay, after the occurrence of certain events which have led to a substantial deterioration of the creditworthiness of the institution promoted by the guarantee (the "Beneficiary"), one or more amounts to the Beneficiary or directly to its creditor(s).

In the case of *credit guarantees*, the undertaking is directly linked to an underlying loan and involves an undertaking from the guarantor to honour the payment obligations of the borrower (the Beneficiary) under the terms of the loan agreement in the event of his default. In this case one can say that the creditor holds a put option on the guarantor since the creditor has, in effect, an option to sell the guaranteed debt to the guarantor at an agreed-upon price, i. e. the face value of the debt.

Another type of financial guarantees is the *standing guarantee*, under which the guarantor, in order to avoid the Beneficiary's liquidation, undertakes to pay to the Beneficiary a predetermined amount or ensures that its share-capital remains intact at all times.

If payment of the guaranteed amount, in whole or in part, has been made, the guarantor normally has the right to demand the amount in question from the Beneficiary (*recourse*).

The relationship between the three parties involved in the issue of a credit guarantee is illustrated below.



The diagram illustrates the point that the guarantor always takes a credit risk in issuing a financial guarantee.

Sovereign guarantees as a political instrument

There are two basic criteria that should be met before the use of sovereign guarantees.

The first criterion is that a long-term assessment of the Beneficiary's performance shows reasonable probability that it will generate sufficient income to recoup its costs. If it fails to generate the necessary income, the State merely defers final financing, since it will have to honour the guarantee at a future date. If, on the other hand, the project is likely to be capable of bearing its own costs, a financial guarantee is a good incentive for the capital market to finance the project. In such

cases the State can use its own funds for other purposes and avoids adding to the State debt.

The other criterion that should be met is that the capital markets are not willing to finance the project at a reasonable price without State support. Typically, this applies to large-scale projects that require long-term financing, i.e. loans with a term of more than 10 years, projects involving appreciable political risks and projects which are difficult for the market to assess due to its unique character.

Where these criteria are met the State may choose between two methods, i.e. it may itself borrow the necessary amount in the credit markets and on-lend it to the project, or it may issue financial guarantees.

In comparison with on-lending, financial guarantees have the following advantages:

- (a) Guarantees are very flexible. The borrowing may be tailored to meet the Beneficiary's current needs as regards the amount, the maturity, the interest structure and the terms of repayment. Whereas, on the other hand, the funds are on-lent by the State, the borrowing must normally be adapted to total public sector borrowing in terms of foreign exchange, maturities and interest rate risks etc.
- (b) Guarantees bring the Beneficiary into direct contact with the credit markets, which offers an important spin-off, particularly with large-scale projects. Only through direct contact with the market will the Beneficiary have quick access to developments in financing arrangements and risk management. Moreover, it is probably easier to recruit a competent finance manager for a borrower who can obtain the required financing directly in the market than if he is referred solely to the State for his financial needs.
- (c) Guarantees lead to diversification. This is a great advantage when the State borrowing requirement is already large. In that case, small, cheap loans with a specific structure may not suit the State's borrowing plans, at least not for that moment. Such loans may therefore suitably be channelled to the Beneficiaries. Depending on the borrowing requirement and administrative constraints, the State may also have decided internally on a minimum amount for loan transactions. Here too, the smaller loans may be used to finance guaranteed projects. Some investors may also prefer "sound" guaranteed projects to loans

raised to cover the "anonymous" budget deficit. Finally, it is probably a good thing even for the State to be open to some competition in its sovereign risk borrowing.

- (d) Loans raised under sovereign guarantees do not increase State borrowing. The larger the borrowing requirement at any given time, the more important this factor is.

Guarantees and credit risks

However, it is important to stress that both on-lending and the issuing of a financial guarantee always involves a credit risk. A price can always be set on a risk, which therefore represents a cost. If State subsidies are not granted, the State must cover the cost of these risks by risk premiums. Some methods for the calculation of those risks are described below. But first we will deal with some measures to reduce risks that can be taken by the State as guarantor.

The most obvious method is for the State to require the Beneficiary to lodge securities for any future recourse. This may be done, for example, by creating a floating charge, a guarantee from the Beneficiary's owners (a counter-guarantee) and/or assignment of future earnings. The alternative is for the Beneficiary to at least undertake not to mortgage its assets, whether present or future, as a security for other undertakings without the State's permission, i.e. a negative pledge.

Furthermore, the State should make sure that the loan is actually used to finance the project being promoted and, as a rule, that the loan is only paid out to keep pace with investment in the project. However, some excess liquidity should be permitted to allow the Beneficiary to take advantage of favourable market opportunities for borrowing and to maintain a certain liquidity in any short-term loan programmes that it has. In that case, however, the State should require that the excess liquidity be invested in an acceptable manner. The State should also ensure that the project is adequately insured.

The guarantee and the underlying loan should be designed in such a way that the State only guarantees the payment obligations arising out of the Beneficiary's borrowing. This may appear obvious. However, particularly in the international capital market, it has become common practice to include an indemnity clause in

the guarantee covering the creditors in the event of the Beneficiary being legally released from these obligations. This can occur where an unauthorised person has contracted the Beneficiary or the Beneficiary lacks legal capacity to enter into the loan transaction. In worst case, such as fraud, the borrowed funds might have been transferred to the wrong account and then disappeared. The rationale for this practice seems to be that the funds are provided against the security of a guarantee and the lender should therefore not be required to bear even the risk of its own inadequate legal work.

In my opinion, the State should only bear the credit risk and not the risk arising out of faulty documentation or other legal matters connected with the loan. These are risks that lenders must always take into account, even in the case of loans directly to States, and they must therefore have established procedures for minimising them, e.g. by examining the Beneficiary's articles of association etc. and requesting legal opinions both from the Beneficiary's in-house counsel and from independent law firms. There is therefore no valid reason why also this risk should be borne by the guarantor. On the contrary, it is in the State's interests to ensure that the loan amount is actually paid out to the Beneficiary and that the lender verifies this in the normal way. In the event of the Beneficiary finding it difficult to raise the necessary loans due to the lenders' doubts as to whether they are dealing with bona fide persons or not, or where the Beneficiary's right to enter into a transaction is in doubt, the State should defer the issue of the guarantee until the matter has been cleared up. Such a situation can indicate that the Beneficiary's administrative procedures are inefficient, which would substantially increase the State's credit risk. In this respect, therefore, lenders should have an incentive to give the Beneficiary the same prudential treatment as they would to borrowers not promoted by sovereign guarantees.

The State should take an active role in the drafting of the underlying loan agreement. Apart from the ordinary default clauses the State should consider to include an equity/assets ratio, a default clause related to the value of the collateral (if any) and clauses to prevent the owners of the Beneficiary to "milk the property" through dividends. In case of breach of these terms the State, as the risk taker, should control any sanction mechanism. For instance, the lender should not in these circumstances have the right to accelerate repayment without the State's permission, but should do so at the State's request. In the case of public bond issues, however, this last principle is for practical reasons difficult to apply.

As soon as it has been issued, the State must ensure active management of the guarantee commitment, which includes risk analysis on a continuous basis. The creditors should be obliged to inform the guarantor immediately in the event of a payment default. (In the case of bond loans this obligation can be imposed on the representative paying agent.) Annual reports, interim reports etc. should immediately be sent by the Beneficiary to the guarantor for analysis. At least in the case of major projects, regular meetings should take place between the guarantor and the Beneficiary. Any application for a respite in repaying the loan must be given careful consideration, taking into account the risk of the State.

Guarantee premiums

As was mentioned above, the State must charge the Beneficiary for the credit risk, unless a State subsidy is involved. The premium must cover the expenses of drawing up the guarantee, including the cost of the first risk assessment and day-to-day administrative costs, and not the least the cost of the credit risk. The last component is of course the most important, but also the most difficult to establish. In order to calculate it the guarantor must carry out a risk analysis for every Beneficiary. The Swedish National Debt Office has in the past used the following table, which was based on historical comparisons, when making its risk assessments.

Annual risk premium as a percentage of outstanding loans	Operational risk			Financial risk		
	low	normal	high	low	normal	high
- 0.5	x			x		
	x				x	
		x		x		
		x			x	
		x	x			x
2-			x			x
c. 1.25			x	x		
c. 1.25	x					x

The analysis of the operational risk focuses on how the Beneficiary's operating income may be affected by its products' sensitivity to business cycles, its competitive advantages in the market, its dependence on key personnel etc.

The financial risk is correlated to the ratio between the Beneficiary's liabilities and its own capital. Typical "key ratios" used in this connection are the equity/assets ratio and interest cover, i. e. the ratio of adjusted income before taxes and interest expense to the interest expense.

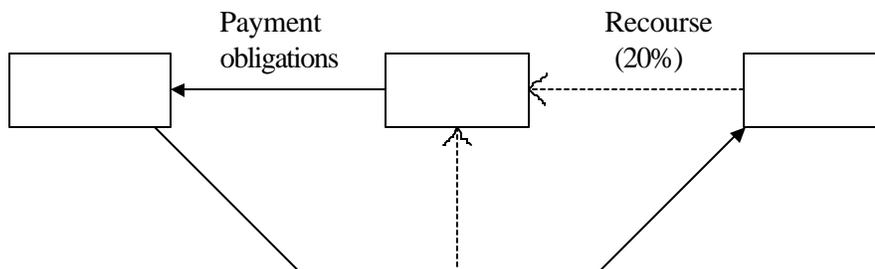
Before the premium is fixed, account must also be taken of the effect of the risk reduction measures described above. In practice, two Beneficiaries with the same operational and financial risk may nevertheless have to pay different premiums for the credit risk.

Another way of assessing the credit risk is to order an assessment from one of the big rating institutes and then fix the premium on the basis of the bond market's risk margin between borrowers with different ratings. The assessment must then be made under the hypothetical assumption that the project does not have access to sovereign-guaranteed financing, i. e. it must be a "stand-alone" assessment. This method has been used by the Swedish National Debt Office to calculate the credit risks in road, tunnel and bridge projects.

As was mentioned at the beginning of this paper, guarantees have much in common with options, and consequently the theories used in the pricing of options may also be applied to the fixing of guarantee premiums.

Lastly, by risk sharing the State can also base the premium on the market's assessment of the risk. This method has been used by the Debt Office in pricing pension guarantees. Risk sharing can be achieved by either reinsuring part of the risk or not guaranteeing the entire credit risk of the lenders.

An example of such reinsurance is given below.



Lender	Beneficiary	Re-insurer
Credit risk (100%)	Recourse (80%)	Counter-guarantee (20% of credit risk)
	Guarantor	

To ensure that the assessment is as reliable as possible, it is advisable that more than one of the above methods are used in calculating the credit risk of the guarantor.

The guarantor's operative goal

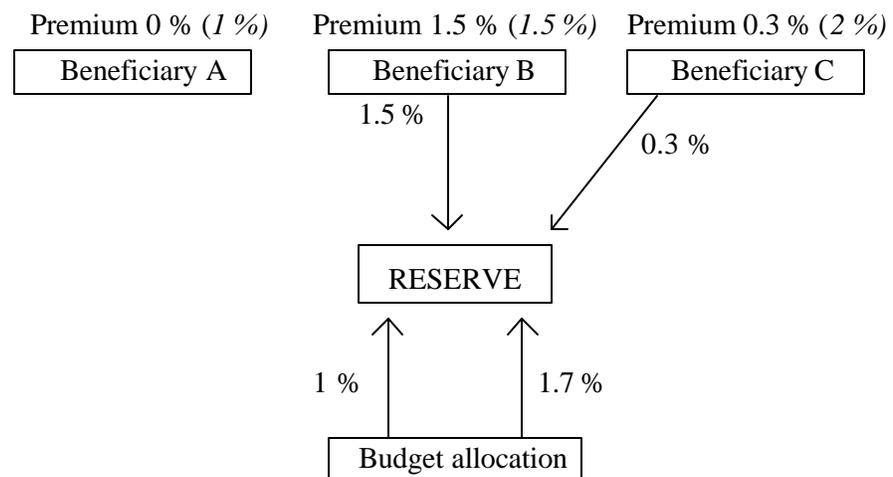
If the State has decided not to grant any subsidies in connection with its guarantees, the long-term aim of the guarantee activities should be to achieve cost coverage by revenue generation. "Long-term" in this connection should mean a period of at least 7-10 years, i.e. a business cycle. It should also be specified whether the premiums are to be differentiated in relation to the various credit risks or whether the State is to charge a uniform premium, for example 2 %, to all Beneficiaries. The problem with the latter solution is that it subsidises Beneficiaries with high credit risks at the expense of those with low credit risks.

Financing guarantee fulfilment

Basically, the State can finance guarantee fulfilment in three ways. *First*, the guarantor can charge the payment against an allocation granted for this purpose (normal budget financing); *second*, the amount can be borrowed off-budget; and *third*, reserves set aside for this purpose can be used. If the third alternative is chosen it must be possible to use the other two alternatives in contingencies, since the market must always be able to rely on the State to discharge its obligations.

The advantage of setting aside reserves is that they represent a buffer for future payments, avoiding the need of sudden increases in the budget load or State borrowing.

Although the determined overall objective of State guarantees might be to avoid the need to pay subsidies, in all probability certain guarantees will nevertheless for political reasons be issued at zero or at very low premiums. This should be taken into consideration when the reserve is built up. One method is to pay the calculated subsidy into a reserve by charging it against a budget account. In such cases the reserve structure may be as follows. (The figures in brackets represent the annual value of the guarantee that corresponds to the actual credit risk.)



Beneficiary C pays an annual, undercharged, premium of 0.3% of the outstanding guarantee amount, while the annual subsidy of 1.7% (2 - 0.3) of the outstanding amount is charged against the budget. In the case of Beneficiary A, with a zero premium, the whole premium must annually be charged against the budget.

The reserve structure can also be used even when the payments under the guarantees are financed via the budget or by borrowing off-budget. When payments are financed via the budget a notional reserve can be entered in the accounts. During the period prior to payments this "reserve" then serves to give warning of future budget expenditure.

When payments are financed by direct loans, funds are actually paid into the reserve. But instead of placing the reserve funds in the market pending any guarantee fulfilment that may arise, these funds are immediately used to finance general State expenditure. In this case the subsidies, if any, are charged against the budget while the current sovereign borrowing requirement in times of budget deficits is not affected by this account-like reserve structure.

In both cases this offers an opportunity to improve budgetary discipline, especially in the latter case since an immediate charge against the budget is shown there.

The annual premiums and subsidies for any project should also be calculated at present value. This enables a comparison to be made with the cost of other economic incentives.

Profit and loss accounts

In order to price the credit risks and report profit and loss accurately, it is important to include all the costs incurred by the guarantee operations in the profit and loss account. The most significant costs are of course guarantee fulfilment.

These costs should, however, preferably be entered in the account as a reservation the moment a significant risk of fulfilment arises and not after payment has actually been made. This speeds up the feedback through the account and creates a compelling incentive for the guarantor to carry out a risk assessment of outstanding commitments at least once a year. For the same reason outstanding recourse claims should be written down to their real values. In the case of guarantees in foreign currencies, exchange losses that are incurred as a result of guarantee fulfilment should be added to the costs. The cost of capital incurred by such fulfilment should also be included, as well as all administrative costs, e.g. salaries, consultants' fees and travel expenses.

Revenues consist mainly of accrued guarantee premiums. Account must be taken of the subsidies referred to above that are likely to arise notwithstanding the declared intention not to grant any subsidies in connection with guarantees. These must nevertheless be calculated and taken into account in assessing the guarantor's

achievement of its operative goals. An important spin-off in this connection is that any subsidies are transparently accounted for.

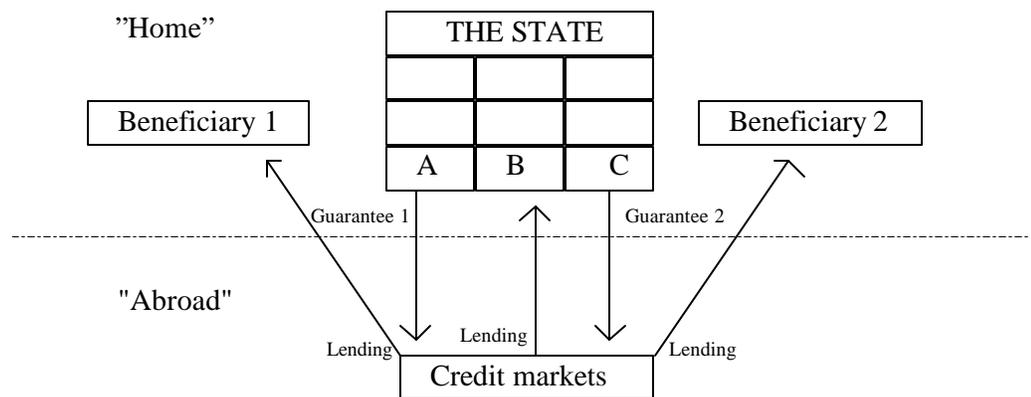
Other revenues may include penalty interest on recourse claims and guarantee premiums, cancellations of previous reserves set aside, appreciation of previously depreciated claims, as well as exchange profits.

To facilitate analysis of profit and loss, guarantee commitments can be broken down by economic sectors. This breakdown should relate to the sectors where the State holds risks, which are not necessarily the same as the sectors that are promoted by the guarantees. The return should be calculated as a percentage of the guarantee commitments outstanding in each economic sector.

Sovereign financial guarantees in relation to sovereign borrowing

There are several linkages between sovereign financial guarantee operations and sovereign borrowing. These are particularly prominent in the case of credit guarantees for foreign loans and sovereign borrowing in foreign markets. They relate both to markets and to legal aspects.

The following diagram illustrates the market linkages with respect to foreign loans.



The lenders in this diagram (the credit markets) take the same credit risk whether they lend funds to Beneficiary 1, the State or Beneficiary 2. The risks are also the

same from the point of view of capital adequacy requirements. Assuming that the loans are similar, the pricing of the loans should therefore be the same. If, owing to the Beneficiary's inexperience or for some other reason, the loans to them will be more expensive than the State would achieve, this can adversely affect the pricing of the State's own foreign borrowing.

The diagram also demonstrates the crucial importance of co-ordination. If all the three parties - Beneficiary 1, the State through agency B and Beneficiary 2 - dash into the same market due to lack of prior consultation between the governmental agencies A, B and C when a favourable market opportunity turns up, it will - apart from the disorganised impression it will create - lead to more expensive loans for all of them comparing to an orderly co-ordination of their market operations.

Another aspect that must be taken into consideration is whether the State should allow all the Beneficiaries to borrow in all the markets. If the Beneficiary has a very weak financial position, the guarantor should at least prevent it from issuing bonds in a large foreign public market, since this might send the wrong signals about the State's own credit status.

When borrowing abroad the State should expect strong pressure from the lenders to restrict its sovereignty during the term of the loan, such as not to withdraw from certain international organisations, not to secure other claims or not to take any other measure that from the lenders' point of view might have an adverse effect on the State's credit status. The State may also be required to waive certain of its right to immunity and to disclose information about its economic and financial position. The usual sanction for a breach of contract is for the lender to demand immediate and full repayment of the loan. Where cross acceleration clauses exist, the entire foreign State debt may become due for payment within a matter of days. The State must also take into account the possibility that these sanctions will be used for political reasons.

Apart from skilful negotiators, it is therefore essential for the State to have complete control over the precise nature of its undertakings.

States will meet the same pressure and requirements in their capacity as guarantors. It is thus important to co-ordinate the borrowing operations with the issuing of guarantees so as to allow a definite and consistent policy to be pursued in

this respect. In the final analysis, national sovereignty, and the limitation of it that the State is prepared to accept, are at stake.

Lastly, cross acceleration clauses in loan agreements often contain a reference to the State's payment obligations under its guarantees, allowing the lender to accelerate the repayment of the outstanding loans if the State fails to honour these obligations punctually.

Organisation

In the light of the above remarks, the most appropriate course is for the State to entrust all its guarantee operations, at least guarantees for borrowing abroad, to a single agency. This governmental agency should, in accordance with clear instructions, perform its tasks as issuer and manager of financial guarantees in accordance with sound economic principles. Any political issues arising out of these operations must be referred to the appropriate political body. For example, if the agency responsible for guarantee operations finds, in connection with recourse, that the soundest economic course is to declare the Beneficiary bankrupt, then it should do so. If the matter is politically sensitive, the decision will have to be made by a political body, for example the Government, but data must be provided on the cost of a remission of the debt or other State bail-outs. The political body must also decide when guarantees are to be issued, and their scope, but the actual issuance and other related measures should be undertaken by the agency itself, outside the political sphere. Experience shows that mixing the political issues and the economic aspects of risky State guarantees can be expensive.

The guarantee-issuing agency must have the necessary competence in the fields of risk assessment, accounting and financial law, as well as experience of both domestic and international credit markets. Its risk analysis expertise could also be used in conjunction with sovereign on-lending involving credit risks.

The problems of price formation and co-ordination described in the preceding section could be solved by ensuring that the governmental agencies A, B and C in the relevant diagram maintain close liaison or that one and the same agency is responsible for all sovereign guarantees relating to foreign loans and all foreign loans

raised by the State. The latter solution has been adopted by Sweden, where the agency in question is the Swedish National Debt Office.

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