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MULTILATERAL-SPONSORED MUNICIPAL BOND INSURANCE: A NEW APPROACH TO PROMOTING INFRASTRUCTURE AND CAPITAL MARKETS DEVELOPMENT IN LATIN AMERICA

Kathleen S. McArthur*

I. INTRODUCTION

FACILITATING urban infrastructure development and promoting the growth of local capital markets are among the most important development objectives for Latin America. For the most part, however, multilateral development organizations such as the World Bank and the Inter-American Development Bank (IDB) have addressed these two development issues separately. Multilateral-sponsored infrastructure development initiatives have focused primarily on providing technical assistance, equity grants, and subsidized bank loans, while capital markets development initiatives have consisted largely of policy-based advising and advocacy of structural reforms. This Note proposes the use of multilateral-sponsored, local-currency municipal bond insurance to the most credit-worthy Latin American municipalities as a more leveraged, holistic approach to promoting development.

Of the few multilateral-sponsored credit guarantee programs that have been implemented, most are designed for private capital investments and, in limited circumstances, sovereign debt securities. A multilateral-sponsored municipal bond insurance program could reduce municipalities' financing costs for specific projects and encourage decentralization within the region, while simultaneously promoting the growth of domestic capital markets by encouraging greater reliance on these markets by Latin

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2. See infra Part III(B)(2) (for a discussion of the guarantee programs of the IDB and the IBRD).
American municipalities. Additionally, the establishment of a municipal bond insurance program would put agents of the multilateral development organizations in direct contact with municipalities, facilitating the delivery of technical assistance to sub-sovereign governments.

Although the major multilateral lending organizations have acknowledged the potential benefits of a bond insurance approach to development, there is not yet a comprehensive bond insurance program available to Latin American municipalities. This Note provides a framework for the establishment of a multilateral-sponsored municipal bond insurance fund for Latin America, referred to hereinafter as an inter-American municipal credit fund (IAMCF or the Fund). Under the design proposed in this Note, an IAMCF would allow broad participation by the IDB, the World Bank's International Bank for Reconstruction and Development (IBRD), and any other organization or entity with an interest in promoting development in Latin America. Part II of this Note presents the scope of development problems to be addressed by the proposed IAMCF. Part III explores the potential benefits of the proposed IAMCF and addresses some of the potential criticisms of the plan. Part IV sets forth a design proposal for an IAMCF and provides specific recommendations for the Fund's legal and financial structure as well as strategies it should employ to minimize risk to its assets. Part V is a conclusion.

3. According to the IDB, “[c]redit enhancement can play an instrumental role in the development of subnational financial markets,” because it can “boost subsovereigns along the steps to cheaper, more efficient, and larger pools of funding.” MAKING DECENTRALIZATION WORK IN LATIN AMERICA AND THE CARIBBEAN: A BACKGROUND PAPER FOR THE SUBNATIONAL DEVELOPMENT STRATEGY 69 (Inter-American Development Bank 2001) [hereinafter MAKING DECENTRALIZATION WORK]. The IDB has also suggested that credit enhancement of municipal debt may play an important role in deepening the “[s]hallow local capital markets” by making the bonds more palatable to private investors. Id. (noting that credit enhancement should address the “constrained market interest” from financiers).

4. The IDB has described the “lack of adequate institutional capacity at the subnational level” as “one of the most important obstacles for the effective decentralization of government,” MAKING DECENTRALIZATION WORK, supra note 3, at 51, and has indicated that the “well-established trend” of decentralization in Latin America will require a dramatic shift in the Bank’s approach to lending for municipal development. Id. at 76. Direct access to municipal leaders will be important if the IDB and other multilateral development organizations are truly to make a difference in the institutional capacity of Latin American municipalities.


6. A number of multilateral development organizations have instituted partial credit guarantee programs, but none have implemented a true bond-insurance type credit enhancement mechanism accessible for sub-sovereign finance. See infra Part III (for details of the World Bank and IDB guarantee programs).
II. SCOPE OF THE PROBLEM

In a 1995 strategy proposal for fostering infrastructure development in Latin America, the IDB identified three areas for action: (1) supporting development of local financial markets, (2) exploring new financing techniques (including bond insurance), and (3) encouraging market-based activities in infrastructure through hemispheric initiatives.7 In the ten years since, change has come slowly, and much of the promise of the 1995 strategy remains unfulfilled. Local capital markets in Latin America remain underdeveloped in spite of the demand-side benefit of the private pension funds that are prevalent throughout the region.8 Ongoing efforts to decentralize government functions are hindered by a lack of good funding options for state and local governments,9 and the multilateral development organizations struggle to reach these entities with appropriate technical assistance. The hybrid approach employed thus far has demonstrated its limitations in addressing the systemic development problems in Latin America. A more holistic strategy, designed to address multiple development hurdles simultaneously, may be a better solution.

A. CIRCULARITY IN CAPITAL MARKETS DEVELOPMENT

Although Latin America has made great strides in the development of its domestic capital markets over the last fifteen years, much work remains to be done as the region continues to rely disproportionately on foreign funding sources, even when compared to other developing countries.10 The nature of capital markets development is such that a problem

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7. Fostering Infrastructure Development, supra note 5, Summary and Recommendations.
9. MAKING DECENTRALIZATION WORK, supra note 3, at 26 (noting that, while there are “compelling reasons for subnational governments borrowing to finance investments in infrastructure . . . [i]there are still few sources of capital for subnational governments . . .”).
10. See Jesse Wright et al., Capital Market Development in Latin American and the Caribbean: A Strategy Proposal, July 1995, available at http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=351749; Eduardo Aninat, Deputy Managing Director of the IMF, Remarks at the Inter-American Development Bank Conference on Capital Market Development (Feb. 5, 2001), available at http://www.imf.org/external/np/speeches/2001/020501.htm (noting that, in spite of significant improvements to local capital markets in the 1990s, “the region still has a long way to go,” and that increasing the depth of the domestic capital markets is one of the greatest remaining challenges); Schmukler & de la Torre, supra note 8 (describing the state of capital markets development in Latin America as particularly disappointing).
of circularity exists: financing infrastructure projects in the local capital markets is too costly because of a lack of demand for local market securities, and the development of greater demand is hindered by the shallowness of the local markets. In Latin America, the most significant demand-side issues have been addressed by the development of private pension systems in the last two decades, which have significantly increased the amount of domestic capital available for long-term investment. Assets under management of private pension funds represent, on average, approximately 10 percent of GDP in the Latin American countries that have privatized their pension systems. In Chile, for example, pension funds exceed 50 percent of GDP. These private pension funds have dramatically reduced the demand-side obstacles to the development of local capital markets, and the greater problem, at this point, is the shallowness of the markets. The success of the private pension funds and continued growth in private, domestic savings depends on the availability of liquid, long-term investment vehicles.

Increased sub-sovereign financing would reduce the supply-side constraints on capital markets development by increasing the depth of the markets and serving as benchmark securities. Most sub-sovereign governments in Latin America, however, do not have the requisite financial sophistication and creditworthiness required for funding capital expenditures by independently accessing the domestic capital markets. What is needed for capital markets development then, is a mechanism for providing targeted technical assistance in conjunction with low-cost credit en-

11. MAKING DECENTRALIZATION WORK, supra note 3, at 66 (noting that “Shallow local capital markets are a major obstacle to encouraging private financing of local ... infrastructure.”).

12. For a discussion of the role of private pension funds in satisfying the demand-side requirements of capital markets development, see ANJALI KUMAR ET AL., MOBILIZING DOMESTIC CAPITAL MARKETS FOR INFRASTRUCTURE FINANCING: INTERNATIONAL EXPERIENCE AND LESSONS FOR CHINA xii (The World Bank 1997) (identifying the accumulation of a contractual savings pool as a first-level imperative for domestic capital market development, with pension funds and life insurance funds considered the most important of such pools).


14. Id.

15. See, e.g., BUILDING LOCAL BOND MARKETS: AN ASIAN PERSPECTIVE 40 (Alison Harwood ed., International Finance Corporation 2000) (noting that the development of local capital markets is important “to meet the growing needs of pension funds by providing long-term, local currency liabilities”).

16. See generally BUILDING LOCAL BOND MARKETS, supra note 15, at 22, 61, 72-73; see also MAKING DECENTRALIZATION WORK, supra note 3, at 69. On the importance of benchmark securities in providing a guide for pricing new issues and deepening domestic capital markets in Asia, see KUMAR ET AL., supra note 12, at 26, 53.

17. MAKING DECENTRALIZATION WORK, supra note 3, at 64 (noting that a majority of Latin American municipalities lack sufficient creditworthiness to access domestic capital markets).
hancement. According to the IDB, such a mechanism would have the potential to address both sides of the circularity problem:

For issuers, credit enhancement has the potential to facilitate access to capital markets, broaden investor participation, and lower the cost of funds. For investors, credit enhancement serves to decrease the risk profile of the transaction by allocating risks (commercial, political, financial, etc.) to the party best suited to manage it.

B. THE NEED FOR SUB-SOVEREIGN FINANCING OPTIONS

For a number of years, the major multilateral development organizations have advocated decentralization, and Latin American governments have begun to pay attention. The IDB has described decentralization in Latin America as "[o]ne of the most remarkable features of the recent history of Latin America and the Caribbean." While the level of decentralization among countries in the region varies significantly, expenditures managed by sub-sovereign governments can account for more than 40 percent of total government expenditures in the most highly decentralized countries.

18. Id. at 66 (explaining that "[m]echanisms that enhance the creditworthiness of local entities" can address both the demand side and supply side obstacles to capital markets development). The need for local-currency credit enhancement in the region has been widely discussed. Following its 1995 strategy proposal, infra Part III, the IDB identified the need for suitable credit enhancement mechanisms as one of three specific challenges related to the development of domestic municipal bond systems in Latin America. FINANCIAL MARKET DEVELOPMENT: ISSUES, STRATEGIES AND INTER-AMERICAN DEVELOPMENT BANK GROUP ACTIVITIES 17-18 (Inter-American Development Bank 1998), available at www.iadb.org/sds/doc/ifm%2Dfinmkt%2D SantiagoE.pdf. A recent report by the Council on Foreign Relations characterized the availability of local-currency credit enhancement mechanisms as critical for Mexican development. BUILDING A NORTH AMERICAN COMMUNITY: REPORT OF AN INDEPENDENT TASK FORCE 14 (Council on Foreign Relations, Inc. 2005), available at http://www.cfr.org/content/publications/attachments/NorthAmerica_TF_final.pdf. In discussing the prospects for municipal bond markets in developing countries, the World Bank stressed the importance of bond insurance "as a mechanism that enhances market acceptability of a debt issue and/or reduces its cost." PROSPECTS FOR DEVELOPING COUNTRIES, supra note 1, at 4.

19. MAKING DECENTRALIZATION WORK, supra note 3, at 69.

20. Id. at 3.

21. Id. The multilateral development organizations have applauded this development, citing the benefits of decentralization, including fostering greater levels of civic involvement, a better matching of government services to community preferences and needs, and increased democratization. E.g., id. And the multilaterals are backing up their policy positions with action—a recent IDB loan to Mexico of $300 million to support decentralization and strengthen state and municipal governments highlights the extent of the multilaterals' commitment to decentralization in the region. Press Release, IDB, IDB Approves Local Currency Option for Mexico Loan: Pilot Project to be Tested in Government Decentralization Program (April 27, 2005), available at http://www.iadb.org/NEWS/display/PRView.cfm?PRNum=8705&Language=english. For a general discussion of the decentralization trend in Latin America, see ERNESTO STEIN, FISCAL DECENTRALIZATION AND GOVERNMENT SIZE IN LATIN AMERICA 1-23 (Inter-American Development Bank 1998), available at www.iadb.org/res/publications/pubfiles/pubWP-368.pdf. For commentary on the advantages and some potential pitfalls of decentralization recognized
This ongoing trend of decentralization has increasingly shifted responsibility for infrastructure development to sub-sovereign governments, and a commensurate need for sub-sovereign financing options has followed. Unfortunately, “[t]here are still few sources of capital for subnational governments and their capacity to acquire debt varies widely.” 22 The World Bank has recognized the need for increased financing options for sub-sovereign governments:

[The combined effect of decentralization and urbanization has increased demand on local governments to provide and finance public services. Against this background, tight fiscal policies have constrained budgetary transfers from central to local governments . . . [resulting] in large funding gaps for local infrastructure investments. . . . As they assume expanded responsibilities in service delivery, the need of local governments to mobilize private debt to fund capital investments is likely to increase. The ability to access credit markets is a function of creditworthiness.] 23

Separately, both the World Bank and the IDB have recognized the significant role a well-functioning municipal bond market can play in infrastructure development by providing a low-cost option for funding local projects. 24 Indeed, recognizing the importance of a municipal finance market, USAID recently created a technical assistance program for Mexico specifically directed at developing such a market. The Mexico program received widespread approval, and in September 2004 USAID announced the institution of a similar program in South Africa. 25


24. SAMIR EL DAHER, THE WORLD BANK, INFRASTRUCTURE NOTES: MUNICIPAL BOND MARKETS: EXPERIENCE OF THE USA, Urban No. FM-8a (Feb. 1997), available at http://www.wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/11/23/00009494600102705411651/Rendered/PDF/multi_page.pdf [hereinafter EXPERIENCE OF THE USA]. The IDB has likewise suggested that accessing the full potential of decentralization and sub-sovereign financing of infrastructure development will “require[ ] . . . the development of long-term debt instruments in the local capital markets,” MAKING DECENTRALIZATION WORK, supra note 3, at 26, and that credit enhancement for the most creditworthy municipalities in Latin America “can form the basis of nascent domestic financial markets, while at the same time demonstrating the value of creditworthiness to other subnational governments.” Id. at 69.

25. The program provides technical assistance to Mexican municipalities in structuring bond transactions secured by both project revenues and federal tax transfers.
In spite of such widespread recognition of the development benefits of a municipal bond market, financing options for most Latin American municipalities remain limited to bank loans and the international financial markets. But the availability of international capital can be unpredictable and may be absent precisely when it is needed most. Bank loans are also an imperfect funding source. When compared to the capital markets, commercial banks are less adept at finely pricing risk through interest rate variations because most bank lending is of a shorter term. In addition, the lending capacity of a single bank is often insufficient to meet the capital requirements of large infrastructure projects.

At the same time, issuing bonds in the international capital markets is an expensive and complicated proposition, available only to the largest, most sophisticated municipalities. The need to comply with unfamiliar and often complicated foreign securities laws and the necessity of including currency swaps or other complex derivative instruments to manage exchange rate risks are examples of the complexities of a bond issue in the international markets. Unsophisticated or infrequent participants in the international capital markets will be ill-equipped to negotiate favorable terms and competitive pricing of derivative instruments.

C. INFLUENCING POLICY AT THE SUB-SOVEREIGN LEVEL

As responsibilities are transferred to lower levels of government, reforms at lower levels of government will become increasingly important. According to the IDB, the complexities of the ongoing decentralization process "are taxing the institutional and financial capacities of subnational governments." Responding to this challenge with changes in the way sub-sovereign governments are financed and managed may be the single greatest challenge of decentralization in Latin America and will require direct technical assistance. The proposed IAMCF would provide

Since its inception, peso-denominated sub-sovereign bond issues have been completed by two Mexican municipalities. For program details, see U.S. DEPT OF STATE, INNOVATIVE MUNICIPAL FINANCING: DEVELOPING LOCAL BOND MARKETS TO SUPPORT INFRASTRUCTURE DEVELOPMENT (Sept. 10, 2004), available at http://www.sdp.gov/initiative/36087pf.htm

26. Bank loans are often considered a less-than-ideal source of financing major long-term capital projects. For an overview of the current international bank lending market, see GLOBAL DEVELOPMENT FINANCE 2004 52-58 (World Bank 2004) (indicating that the 2003 rebound in international lending came against the backdrop of a global retrenchment that began in 1997 and giving specific examples of countries opting out of the bank lending market when local capital markets financing is available).

27. See Kumar et al., supra note 12, at 1.

28. Id.

29. For a description of the reasons that foreign borrowing may be a complement to, but is not a substitute for, local capital markets debt funding for municipal projects, see PROSPECTS FOR DEVELOPING COUNTRIES, supra note 1.

30. Id.

31. Id.

32. MAKING DECENTRALIZATION WORK, supra note 3, at 17.

33. Id.
multilateral development organizations a direct line of communication with state and local governments in Latin America, facilitating the delivery of such advice.

The proposed IAMCF could also be used as a tool for managing decentralization and encouraging appropriate reforms at the local level through focused conditionality. Policy-based lending has long been used by multilateral lenders to influence the internal decision-making processes of borrower countries, and there is already some precedent for using development assistance to promote appropriate reforms at the sub-sovereign level. In April 2005, the IDB announced a $300 million loan to Mexico, the purpose of which was to operate "[a]s an incentive for Mexican subnational governments to undertake reforms and adopt best practices such as transparency in budgeting and spending." 34

Recently, traditional conditionality has been heavily criticized, 35 and multilateral organizations are reexamining their policies in this area. The World Bank recently announced a review of its conditionality practices in policy-based lending in an effort to identify "new approaches to . . . implementation issues" and to "determine the appropriate level, content, and scope of conditionality." 36 What lurks on the horizon is hard to characterize with any specificity, but it seems inevitable that whatever new model for conditionality unfolds, it will incorporate an emphasis on assistance rather than imposition. As decentralization continues in Latin America, an individualized approach to policy-based development assistance will likely require greater interaction between the multilateral development organizations and the state and local governments in the region.

D. THE NEED FOR A HOLISTIC APPROACH TO CAPITAL MARKETS AND INFRASTRUCTURE DEVELOPMENT IN LATIN AMERICA

Collaboration and a systemic approach to development present a real possibility of breaking through the circularity barrier that impedes capital markets development in Latin America. The IDB has acknowledged the importance of strengthening its relationships with other international financial institutions in its efforts to develop domestic capital markets, to avoid "reinvent[ing] the wheel." 37 Correspondingly, the IDB’s Eighth Capital Replenishment established

\[ \text{a mandate for the Bank to work with a more comprehensive approach to development that seeks to consolidate economic reforms while also promoting internal socioeconomic cohesion, regional inte-} \]

34. Press Release, IDB, supra note 21.
35. See infra Part III(B)(3).
37. FINANCIAL MARKET DEVELOPMENT, supra note 18, at 23.
The development problems facing Latin America are highly interrelated, and a compartmentalized approach to development will be insufficient to address these issues effectively. The region requires more multifaceted programs that can address a variety of development issues simultaneously, along with greater collaboration among the multilateral development organizations that are active in the region.

III. ADVANTAGES AND DISADVANTAGES OF AN IAMCF

While consistent with the goals of limited guarantee programs already established by multilateral development organizations, the proposed IAMCF would represent a significant departure from the status quo in the way these organizations approach the development problems introduced in Part II. This part presents the potential benefits of the proposed approach and addresses some potential criticisms and risks of a multilateral-sponsored municipal bond insurance program.

A. BENEFITS OF A BOND INSURANCE APPROACH TO DEVELOPMENT

1. Reducing the Cost of Capital and Stimulating Increased Issuance

An IAMCF would promote infrastructure development by reducing interest costs for projects financed in the local capital markets, wrapping low investment-grade debt with insurance so bonds can be marketed at local-AAA pricing. Because the interest cost is normally the greatest portion of any long-term capital financing, the potential economic benefit of bond insurance to any single project is significant. The power of municipal bond insurance is evidenced by its widespread use in the United States, where nearly 50 percent of all municipal bonds, and as many as 75 percent of issues carrying underlying ratings of BBB or A, were covered by bond insurance as of 1997.

The potential economic benefit of bond insurance to municipal financings in Latin America is difficult to quantify. The underdeveloped state of the domestic capital markets makes it difficult to predict credit spreads...
with great precision. In the absence of current data, however, it seems likely that local currency credit spreads in Latin America would exceed U.S. municipal credit spreads. The Bond Buyer's Municipal Market Yields Report shows a credit spread of sixty-five basis points for thirty-year BBB tax-exempt bonds over AAA tax-exempt municipals. Assuming domestic credit spreads in Latin America were only ten basis points higher (and they could be much higher), for a thirty-year, $40 million par bond, the dollar cost of a seventy-five basis point reduction in the bond interest rate from 10 percent to 9 percent would be approximately $10.5 million. Even on a present value basis, discounted at 5 percent, the benefit of this interest cost reduction is more than $5.6 million. This savings would constitute a significant economic benefit to infrastructure development projects. In turn, this reduction on the cost of local currency borrowing in a country's domestic capital markets would stimulate greater reliance on these markets for financing municipal infrastructure development. As noted previously, the resulting increase in supply of long-term, high-grade paper in the domestic capital markets could have a substantially beneficial effect on the growth of these markets.

2. Increasing the Leverage of Multilateral Development Aid

Presently, most infrastructure development aid is transmitted in the form of direct loans or equity investments. Under this model, a single dollar of aid money can only be given once. By contrast, leverage of 2 to 2.5 times for bond insurance funds in an IAMCF would probably be acceptable. Leverage is an important element of the monoline bond insurers' business model and is fundamental to most forms of credit en-

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41. The credit spread is the difference in interest rates for securities of equivalent tenor but different credit ratings. An example would be the difference in rates for a long-term mxAAA bond and a mxBBB bond. The difficulty in predicting credit spreads in underdeveloped markets is commonly understood and was confirmed by Brian Weinstein, Managing Director and Trader of Latin American securities at Merrill Lynch. E-mail from Brian Weinstein, Managing Director and Trader of Latin American Securities, Merrill Lynch, to Kathleen McArthur (May 10, 2005, 11:49:02 EST) (on file with author).

42. BondBuyer Online (current as of May 6, 2005) (available by subscription only).

43. The IDB aggregates loans and guarantees in its financial statements, so the exact breakdown is difficult to quantify. But of the nine projects approved by the IDB's private sector department in fiscal 2004, only two were guarantees (partial credit guarantees). INTER-AMERICAN DEV. BANK, ANNUAL REPORT 32 (2004). An analysis of the 2003 annual report of the International Finance Corporation (IFC) showed that guarantees of any variety comprised less than 1 percent of the IFC's total support in Fiscal 2002 and only 1.05 percent in Fiscal 2003. INT'L FIN. CORP., ANNUAL REPORT (2003).

44. The IBRD does leverage its resources to some extent by borrowing funds at a low cost on the international capital markets and using those funds to provide loans to borrower countries. But this leverage comes at a cost: in addition to assuming the risk of borrower default (which should be identical in a bond insurance approach), the IBRD must repay the interest on the bonds it sells to raise funds for its loans. Even at very low rates, that interest component can become a significant cost over time.

45. See EXPERIENCE OF THE USA, supra note 24, at 1-4.
hancement. The State of Texas, for example, has established a credit enhancement for its public schools that functions in a manner similar to that envisioned for the proposed IAMCF. The state-approved leverage capacity for that fund is 2.5 times the lesser of cost or market value of assets in the fund.

The inferior credit quality of borrowing municipalities in Latin America may increase the risk of default, which would suggest a more conservative capacity limit for the proposed IAMCF, compared to the Texas fund. But the Texas fund, like the commercial bond insurers, carries a global AAA rating. To fully promote its stated objectives, the proposed IAMCF would need only a local-AAA rating. As such, it seems reasonable to expect that the IAMCF could support a leverage ratio comparable to that of the Texas fund.

3. Facilitating Combined Action for Economies of Scale

The administrative costs of any credit enhancement program are sure to be significant. Administrative expenses for the IBRD, for example, amounted to $934 million in fiscal 2004–0.9 percent of the bank’s outstanding loans. Coordination among the multilateral institutions, to avoid duplicative efforts, will create obvious economies of scale in this regard. The substantial additional benefit of simplicity is more difficult to quantify but should be equally apparent. The ability of Latin American sub-sovereign governments to take advantage of the resources of a multilateral-sponsored municipal bond insurance program, including the technical assistance elements, will be greatly enhanced by a unified approach. For example, a streamlined application process for credit enhancement and a single point of contact for the sub-sovereign governments will reduce the obstacles they face in accessing the domestic capital markets. Given the substantial hurdles already to be overcome, the value of a simplified solution truly is difficult to understated.

46. Texas’ Bond Guarantee Program was created from the state’s Permanent School Fund in 1983. Since that time, the Program has guaranteed more than $47 billion in school district bonds, providing a cost-free Aaa wrap for Texas school districts. As of August 31, 2004, the ratio of guaranteed debt outstanding to the book value of the Fund was 1.82:1. Tex. Perm. Sch. Fund Ann. Rep. 49 (2004) [hereinafter, Tex. PSF Annual Report].

47. Bryan Indep. Sch. Dist., Preliminary Offering Statement, Unlimited Tax School Building Bonds, Series 2005A at 20 (2005) (on file with author) [hereinafter Bryan ISD POS]. Note that the actual leverage of the fund varies and additional caps are imposed by the IRS. The IRS caps have proven more restrictive than the statutorily-mandated caps, and the state is therefore seeking relief in a private letter ruling. Tex. PSF Annual Rep., supra note 46, at 49.


49. The IDB and IBRD are already partners in co-financed trust funds of $3.7 billion, and the economies of scale gained through collaboration are sure to have been a factor in the decision to work together. Id. at 114.
B. POTENTIAL CRITICISMS OF THE BOND INSURANCE APPROACH

1. Credit Enhancement Should be Left to Commercial Actors

Ideally, credit enhancement for sub-sovereign debt in Latin America would be provided by the private sector. Many of the major monoline bond insurers have established Latin America practice groups and are actively pursuing project finance business in the region.\(^{50}\) Still, not all infrastructure development in Latin America can or should be accomplished through privatized, project finance transactions, and private bond insurers are ill-equipped to handle exposure to sovereign risk.

In a recent telephone interview, Allison Kingsley, a Vice President at Ambac Financial Group, confirmed the insurer’s reluctance to assume sovereign risk, noting that almost all the Latin American transactions insured by Ambac have incorporated a structure that bypasses country risk by moving assets offshore.\(^{51}\) This appears to be a function of the firm’s unfamiliarity with the markets, since Ms. Kingsley noted that Mexico has graduated from this type of approach, largely because the country’s geographic proximity and close integration with the United States through NAFTA have allowed the firm to grow comfortable with the kinds of risks it faces there. Still, Ms. Kingsley indicated that these have been traditional project finance transactions, since the firm is still not prepared to wrap pure sovereign, or sub-sovereign, bonds.\(^{52}\)

Even if commercial bond insurers were suitably disposed to assuming pure sovereign risk in Latin America, their capacity to replace the proposed IAMCF might still be constrained. In a 1997 World Bank Infrastructure Note, Samir El Daher noted that the extension of true municipal credit enhancement by the commercial bond insurers, “would [likely] be contingent inter alia upon the existence of: a large pool of debt instruments, including corporate and municipal issues, which could be insured—allowing for the necessary diversification underpinning the insurance concept; and consistent credit ratings that respond to the credit-conscious investor base of the municipal markets.”\(^{53}\) But, as discussed in Part II(A), a circularity problem continues to plague the region. The accumulation of a large pool of debt instruments, the supply-side of capital markets development, will depend on issuers’ being able to access the market in a cost effective manner. Within the U.S. municipal finance industry, bond insurance has been important for achieving this cost-effectiveness.\(^{54}\)

Pricing issues may also prevent commercial bond insurers from participating effectively in Latin American domestic capital markets. All of the

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50. MBIA, Ambac and XL Capital Assurance have all participated in project finance transactions in Latin America.
51. Telephone Interview with Allison Kingsley, Vice President, Ambac Financial Group, Inc. (May 4, 2005).
52. Id.
53. PROSPECTS FOR DEVELOPING COUNTRIES, supra note 1, at 4.
54. See EXPERIENCE OF THE USA, supra note 24, at 4.
major monoline bond insurers are of the highest credit quality and carry a global-AAA rating. Maintaining this credit rating entails costs, and those costs must be passed on to the entities who take advantage of that rating. Within the domestic capital markets of Latin America, however, a global-AAA rating, compared to a local-AAA rating, may be overkill, since domestic investors will already be carrying country risk.55

Finally, it is worth noting that the activities of profit-driven commercial bond insurers may not be compatible with the specific needs of the region. Although there is a way to structure a local currency municipal bond insurance program with broad development benefits and minimal risks, it is unclear that such a structure would be profitable. Moreover, the business model of commercial bond insurers is not equipped to provide the kind of complementary technical assistance that sub-sovereign governments will require as they access the capital markets for the first time. This assistance will be critical to ensuring the success of sub-sovereign governments in their first bond issuances, because, as the International Finance Corporation recently wrote, “[w]e have all learned that building market infrastructure is not the same as building a market. It does not ensure market participation.”56 As non-profit seeking entities, the multilateral development banks should act to fill the gap between what should be done and what profitably can be done.57

2. Sufficiency of Existing Program

A second potential criticism of the proposed IAMCF is that it is an unnecessary complication because almost all of the major multilateral development organizations operate some sort of credit guarantee program and are active participants in syndicated loans.

The existing program that most resembles the proposed IAMCF is the recently reinstated Guarantee Disbursement Loan (GDL)—pilot program of the IDB. This $1 billion initiative gives IDB borrower countries

55. See, e.g., GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENT AND ISSUES SEPTEMBER 2005 103 (International Monetary Fund 2005), available at: http://www.imf.org/External/Pubs/FT/GFSR/2005/02/index.htm (noting that the level of creditworthiness required for investment-grade ratings on the global scale is higher than what is required for local investment-grade ratings). It is true that the same ratings-overkill argument would be applicable to a bond insurance program sponsored directly by the IDB or the IBRD, because both organizations carry global-AAA ratings. The proposed structure for the IAMCF addresses this concern by establishing the fund as a remotely capitalized trust fund under the auspices of the IDB. In this way, the IAMCF could be structured to obtain a lower credit rating, more accessible to Latin American sub-sovereign governments, without jeopardizing the global reputation of the IDB itself. For further discussion of this problem, see infra Part III(2)(B).
56. BUILDING LOCAL BOND MARKETS, supra note 15, at 40.
57. This is consistent with the general philosophy of the multilateral development banks. In its most recent annual report, the World Bank had this to say regarding profit: “As a cooperative institution IBRD seeks not to maximize profit but to earn a return on assets sufficient to ensure its financial strength and sustain its development activities.” THE WORLD BANK, ANNUAL REPORT, supra note 48, at 106.
the option to convert a disbursement to a guarantee, which can be used to enhance notes issued in the capital markets.\textsuperscript{58} Since its initial instatement on October 18, 2000, the program has been discontinued, amended, and reinstated, and in that time period has never been used.\textsuperscript{59} As initially conceived, the GDL program charged a 200 basis point fee for the loan-to-guarantee conversion option, which could not be removed even if the borrower country never exercised its option to convert the approved loan capacity to a guarantee.\textsuperscript{60} But an amendment to the GDL program eliminated this fee, and fees under the GDL program are now equivalent to the rates applicable to the underlying loan.\textsuperscript{61}

The primary feature distinguishing the GDL program from the proposed IAMCF is that it requires a central government guarantee. Rather than providing guarantees directly to sub-sovereign governments, the GDL program provides guarantees to central governments, the benefits of that could be passed on to sub-sovereign governments if the country so desired. As such, the GDL program does nothing to increase the contacts between multilaterals and sub-sovereign governments. The IDB also provides Political Risk and Credit Guarantees.\textsuperscript{62} These guarantees are appropriate for public-private partnership initiatives but are not available for pure municipal bond transactions.\textsuperscript{63}

The IBRD offers Partial Risk, Partial Credit and Policy Based Guarantees. Of these, only the Partial Credit Guarantees are comparable to the bond insurance that would be provided by an IAMCF.\textsuperscript{64} Like the pro-

\textsuperscript{58} \textit{INTER-AMERICAN DEV. BANK, GUARANTEE DISBURSEMENT LOANS (GDLs) WITH SOVEREIGN GUARANTEE: PROPOSAL FOR REINSTATEMENT OF AND AMENDMENTS TO THE PROGRAM}, \textsection 2.1 (Mar. 4, 2003), available at http://www.iadb.org/ext/gdl03eng.pdf.

\textsuperscript{59} \textit{Id.} \textsection 1.2.

\textsuperscript{60} \textit{Id.} \textsection 2.5.


\textsuperscript{62} The IDB's Political Risk guarantees provide coverage for 50 percent of project costs or $150 million, whichever is less, for breach of contract, currency convertibility, transferability, and other political risks. Comprehensive credit guarantees are limited to the lower of 25 percent of total project costs or $75 million in most countries, although in countries with "limited capital markets access," credit guarantees can cover up to 40 percent of project costs while not exceeding $75 million. For a full description of the IDB's Guarantee Program, see Inter-American Dev. Bank, \textit{About the IDB: Guarantees}, http://www.iadb.org/aboutus/111/figuarantees.cfm?language=english (last visited Oct. 7, 2005).

\textsuperscript{63} IDB Political Risk and Credit Guarantees are available only to private sector companies, where private investors control at least 50 percent of the borrower's shares. Generally, private sector companies must also provide 50 percent of the costs for the project to be financed. For a description of the IDB's eligibility requirements, see Inter-American Dev. Bank, \textit{Private Sector Department: Eligibility Requirements}, http://www.iadb.org/pri/eligibility.cfm?language=EN&pard=8 (last visited Oct. 7, 2005).

\textsuperscript{64} The IBRD's Partial Risk Guarantees are essentially political risk insurance policies. They protect private lenders from specific political risks, including expropriation, obstruction of arbitration, foreign exchange controls, etc. The Policy Based Guarantees are designed to support access by central governments to the international capital markets. The Policy Based Guarantee Program currently in place
posed IAMCF bond insurance, the World Bank's Partial Credit Guarantees protect private lenders against all risks during a specific financing term of debt and are available in the local currency. By covering a portion of the debt service period, Partial Credit Guarantees are designed to extend the maturity of debt financing beyond what would otherwise be available in the market.

The IAMCF proposal differs from existing programs in a few ways that may be material. First, the proposed IAMCF would offer the benefit of simplicity, since credit enhancement for the entire principal amount of a bond issue would be available to qualifying sub-sovereign governments. Both the IDB and the IBRD generally refuse to provide credit enhancement for the full amount of a transaction. The proposed IAMCF also would provide the benefits associated with remote capitalization: greater flexibility, limited exposure of the institution's asset base, facilitated third-party participation, and the elimination of the ratings-overkill problem. The guarantee programs of both the IDB and the IBRD have improved dramatically in the last few years and are well designed to facilitate infrastructure development and may indeed support growth in the local capital markets of Latin America. Nonetheless, the proposed IAMCF would offer important advantages in the specific context of decentralization and should be considered as a supplement to the guarantee programs already in place for the region that would address the specific development hurdles identified in Part II.

3. Conditionality Complaints

Conditionality in multilateral lending has been heavily criticized. These criticisms may become increasingly vocal as the use of conditionality to effectuate rich-country objectives spreads. When conditionality is applied directly to local governments rather than through the prism of the central government, there may be a greater perceived threat to sovereignty. This concern, however, might be adequately addressed through a good public relations strategy, especially since the reforms needed at the sub-sovereign level are likely to be narrower in scope than the macroeconomic policy shifts required at higher levels of government. Moreover, the imposition of reform requirements by the proposed does not address sub-sovereign access to capital markets. For a description of the World Bank's guarantee instruments, see The World Bank, Guarantees: Guarantee Instrument, http://web.worldbank.org/WEBSITE/EXTERNAL/PROJECTS/EXTFININSTRUMENTS/EXTGUARANTEES/0,,contentMDK:20191686--menuPK:64143504--pagePK:64143534--piPK:64143448--theSitePK:411474,00.html (last visited Oct. 7, 2005).

65. The IDB is constrained from covering the full amount of a project by rules capping its participation in any particular project at 60 or 70 percent of total project costs, respectively, for countries in Groups A and B. See Inter-American Dev. Bank, Borrowing Member Countries, http://www.iadb.org/aboutus/VI/borrowing.cfm?language=english (last visited Oct. 7, 2005). See infra Part IV(A)(3).

66. For an overview of the criticism, see Mary C. Tsai, Globalization and Conditionality: Two Sides of the Sovereignty Coin, 31 LAW & POL'Y INT'L BUS. 1317 (2000).
IAMCF would be accomplished more through incentive strategies (i.e., by implementing such reforms, lower-cost financing options would be made available) rather than through strict conditionality in lending, which may be more palatable. Also, the establishment of strict standards at the outset of the program might avoid the sense of entitlement that contributes to a negative public perception of conditionality in traditional lending.

IV. DESIGN PROPOSAL FOR AN IAMCF

Part IV provides a suggested legal framework for the structure of the proposed IAMCF, as well as specific recommendations for criteria the Fund should incorporate in its requirements.

A. LEGAL STRUCTURE

A first-level obstacle to creating an IAMCF is the identification of an appropriate legal structure for broad multilateral participation and responsible asset protection. This section examines the legal constraints presented by the organizational mandates of the IBRD and the IDB and presents a recommendation as to how the Fund might be structured to permit full participation by both organizations and encourage additional support from interested third-parties.

1. Proposed Legal Structure

An ideal structure for the proposed IAMCF would be a remotely capitalized Trust Fund, administered by the IDB. This structure would protect the core assets of the multilateral development organizations and permit broader participation in capitalizing the Fund. Participation in such a fund would be available to both the IBRD and the IDB, as well as to any IDB donor countries or other multilaterals or non-governmental organizations that might wish to contribute.

The IBRD could contribute to the proposed IAMCF via a transfer of allocable net income from the IBRD. Each year, the IBRD earns income from loans, investments, and equity contributions. In fiscal 2004, after accounting for all administrative costs and loan-loss provisioning expenses, the bank was left with $1.675 million in allocable net income. According to the bank’s 2004 Annual Report, IBRD’s allocable net income serves several purposes related to the Bank’s mission . . . . It enables IBRD to respond to unforeseen humanitarian crises and to provide grants or other support for worthy


68. THE WORLD BANK, ANNUAL REPORT, supra note 48, at 105.
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causes. IBRD also regularly shares income with its borrowing members through partial waivers of commitment fees and, for qualifying borrowers, waivers of contractual interest charges on loans.69

By providing a transfer of net income to a special IAMCF trust, the IBRD could participate in the Fund’s development work without exposing the bank’s equity shareholders to undue risk.

The IDB could also provide funds to a remotely-capitalized IAMCF. The IDB’s governing agreement specifies that the resources of the bank shall be used exclusively to implement the functions articulated in article I of the agreement, including the promotion of the investment of private and public capital for development purposes.70 The bank is also authorized to supplement private investment when private capital is not available on reasonable terms.71 Any use of IDB resources must also be consistent with the bank’s defining purpose of contributing to accelerated economic and social development of its borrower countries.72

Contributions to the proposed IAMCF would clearly be consistent with these requirements. As the IDB itself has recognized, credit enhancement for subsovereign bonds would address the shallowness of local capital markets and thereby remove “a major obstacle to . . . private financing of local . . . infrastructure.”73 Furthermore, the major bond insurers have made it clear that they are not prepared to provide this important service.74 As explained above, municipal bond insurance could stimulate greater capital markets development and reduce the cost of infrastructure improvements; both are clearly consistent with the principles governing the use of IDB resources.

A more significant obstacle to IDB participation is the fact that the bank’s governing agreement includes specific language governing loans and guarantees made by the bank75 but does not give similar explicit authorization for a transfer of funds for other purposes. As such, the IDB would likely need to rely on its broader discretionary authority to invest funds not needed for operations “in such obligations as it may determine.”76 Importantly, a three-fourths majority of the IDB’s member countries would be required to agree to any contribution to the IAMCF under this approach.77

2. The IBRD

Providing bond insurance would not violate the IBRD’s Articles of

69. Id. at 107-08.
71. Id. art. I § 2(a)(iii).
72. Id. art. III § 1, art. I § 1.
73. Making Decentralization Work, supra note 3, at 66.
74. See infra Part III(B)(1).
75. Id. art. III.
76. Id. art. VII § 1(iii).
77. Id.
Agreement, but there are two important legal reasons why it should not be done directly through the bank, in addition to the need to limit the exposure of the IBRD's asset base.

First, article III section 2 of the IBRD's Articles of Agreement, specifies that "[e]ach member shall deal with the bank only through its Treasury, central bank, stabilization fund or other similar fiscal agency, and the bank shall deal with members only by or through the same agencies." A primary goal of the proposed IAMCF would be the promotion of decentralization of government, and restraints on a municipality's ability to deal directly with the Fund and its representatives would run contrary to this objective. In addition to adding an unnecessary level of bureaucracy, such a requirement would hinder true decentralization by continuing to tie municipal development to central government agencies.

Second, while article III, section 4 permits the bank to guarantee, participate in, or make loans to its members and their political subdivisions, that permission is subject to a number of conditions, including a requirement that "the member or the central bank or some comparable agency of the member which is acceptable to the Bank, fully guarantees the repayment of the principal and the payment of interest and other charges on the loan" whenever the member country is not itself the borrower. This requirement would undo much of the progress of decentralization, by once again forcing central governments to take responsibility for the obligations they had previously passed on to the state and local governments. By using its discretionary authority to transfer a portion of allocable net income to the proposed IAMCF, the IBRD could participate in a true municipal bond insurance program free from these burdensome constraints.

3. The IDB

As is true for the IBRD, establishing an IAMCF as part of the IDB would be legally possible because the IDB's governing Agreement grants it broad authority for providing guarantees. Under the Agreement, the IDB may guarantee loans with its "ordinary capital resources or the resources of the [Special Operations] Fund, in whole or in part." The requirements imposed by the Agreement for guarantees by the IDB are less restrictive than those of the IBRD. The Agreement requires the ap-
plicant to submit a detailed proposal and specifies that the bank consider the borrower's ability to obtain private financing on reasonable terms, pay due respect to the borrower's ability to repay the loan, and confirm that the proposed debt service amortization schedule is reasonable for the proposed project. Additionally, the bank is required to receive "suitable compensation for its risk" in guaranteeing loans made to other investors. All of these requirements are entirely consistent with a traditional bond insurance model and represent good practices for any guarantee activity.

The only real limitations on the IDB's ability to sponsor the proposed IAMCF are the caps on IDB participation in project costs. For countries in Groups A and B, the bank's participation is capped at 60 and 70 percent of total project costs, respectively. This cap could be dealt with in a variety of ways, but a limit on IDB participation in a remotely capitalized IAMCF is probably the simplest. If the IDB's annual contributions to the proposed IAMCF were capped at 60 percent of the fund's asset base, with funds from the IBRD and any interested third-parties accounting for the difference, the IDB could be assured that its funds would never account for more than 60 percent of the credit enhancement provided to any particular project.

B. Operations

To best address the development issues identified in Part II, the operations of the proposed IAMCF should be governed by a few guiding principles. First, the kinds of securities for which IAMCF bond insurance will be available should be specifically identified. Second, the general policy on fees should be clearly articulated, such that IAMCF administrators will be able to set fees accordingly. Third, a plan for hedging foreign exchange rate risk should be created. Fourth, the purpose and scope of the proposed IAMCF's technical assistance program should be devel-

83. Id. art. III § 7(a).
84. Id.
85. Id. art. III § 7.
86. These countries represent the most developed of the IDB borrower countries, including Argentina, Brazil, Mexico, and Venezuela (Group A) and Chile, Colombia, and Peru (Group B). At least initially, most of the Latin American municipalities for which bond insurance would be appropriate would fall within these seven most developed countries. Inter-American Dev.Bank, Borrowing Member Countries, http://www.iadb.org/aboutusVI/borrowing.cfm?language=english (last visited Oct. 7, 2005).
87. Id.
88. Another possibility would be to have the Bank simply grant an exception to the caps for purposes of IAMCF bond insurance, since the caps do not seem to be required by the Bank's governing agreement. Alternatively, a policy decision might be made to limit IAMCF insurance to 60 or 70 percent of project costs. While this limitation would not be ideal, it would provide municipal borrowers the opportunity to issue two tranches of debt in the capital markets and benefit from the credit enhancement on the longer-term maturities. Since credit spreads are typically narrower for shorter-term maturities, this limitation might not unduly impact the potential benefit of the IAMCF insurance.
oped. Finally, appropriate measures for dealing with default should be implemented. This section provides a set of recommendations for each of these five areas of Fund operations.

1. **Qualifying Securities**

   The most important requirement for IAMCF bond insurance will be the municipal nature of the bonds to be insured; the insurance should be available for any true municipal bonds issued by sufficiently creditworthy municipalities. Credit enhancement may be particularly valuable for municipal revenue bond transactions, but it should be equally available for general obligation bonds of the sub-sovereign government.

   IAMCF credit enhancement most likely should not be provided for project finance transactions. Existing multilateral guarantee programs already address this sector in a limited manner, and commercial bond insurers have indicated their willingness and ability to participate in these transactions where appropriate.

2. **Fees**

   The IAMCF should charge a fee commensurate with the amount of risk it assumes, which would generally be proportional to the economic benefit provided by the guarantee. For example, if the uninsured bond issue would have carried a rating of mxA-, the bank might charge a per annum fee equal to 50 percent of the difference in interest rates between mxA- bonds and mxAAA bonds. Note that this 50 percent figure has been arbitrarily assigned. The precise portion of the credit spread benefit to be retained by the issuer is a question of strategy that would need to be evaluated in conjunction with detailed projections of the Fund’s operating expenses and the likelihood of default in a given situation. The cost of any currency hedge transactions put in place by the proposed IAMCF should be passed on to the borrower as part of the fee. This approach would be consistent with the fee structures already used by the major multilateral development organizations in their existing guarantee programs.

3. **Hedging Exchange Risk**

   A primary benefit of local currency financing is the elimination of cur-

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89. This is because it may be difficult for individual domestic investors to accurately price the risks associated with a given undertaking, especially since many of the improvements will rely on newly created cash flow streams that have not been tested.

90. The Articles of Agreement for the IBRD require that the Bank charge a guarantee fee paid periodically at a per annum rate “not less than one percent” during the first ten years of the Bank’s operations. IBRD Articles of Agreement, supra note 78, art. IV § 5. The IDB assesses fees in a similar manner. IDB Establishing Agreement, supra note 70, art. III, § 11(a).
rency mismatch between project revenues and loan payments.\textsuperscript{91} As a regional institution, the proposed IAMCF will inevitably face currency exchange risks, since it will provide bond insurance coverage in a variety of local currencies. As a repeat-player in the global derivatives market, however, the proposed IAMCF might be in a better position than Latin American subsovereign governments to obtain currency hedging instruments at competitive prices. Even if cost savings do not materialize within the pricing of hedge transactions, the administrative benefits of shifting exchange risk to the proposed IAMCF might be enormous. The learning curve for understanding derivative transactions can be a significant additional burden to first-time municipal bond issuers. Removing this educational barrier would greatly reduce the difficulties a municipality would face when entering the local capital markets for the first time, encouraging greater participation in these markets by eligible municipalities.

In assuming the currency and conversion risk itself, the proposed IAMCF would need to hedge that exposure and pass the costs of those hedge positions on to the issuing municipalities. Ideally, the Fund would follow the model of commercial bond insurers in managing exchange rate risk by including currency swaps to hedge their positions in each and every Latin American transaction they insure.\textsuperscript{92} As discussed above, the cost of these swap transactions could be passed on to issuers as a component of the IAMCF bond insurance fee.

4. Technical Assistance Program

Technical assistance for sub-sovereign governments accessing the capital markets for the first time will be an important element of the proposed IAMCF’s operations. Government officials will need to understand any new reporting requirements that a capital market issuance may entail. Governments that have not previously borrowed large sums will need to understand the difference between borrowing to finance capital improvements and borrowing to fund current expenditures.\textsuperscript{93} Education on good liquidity management practices and the cost-of-carry\textsuperscript{94} will be particularly important, since these concepts may be unfamiliar to governments that have been accustomed to construction-loan type financing arrangements, where project funds are drawn down as

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\textsuperscript{91} In a recent press release, the IDB acknowledged the value to local governments of a local currency funding option as instrumental in its decision to include a local currency conversion clause in a $300 million loan to Mexico. Press Release, IDB, \textit{supra} note 21.

\textsuperscript{92} Telephone Interview with Allison Kingsley, \textit{supra} note 51.

\textsuperscript{93} \textit{SPECIALIZED FINANCIAL INTERMEDIARIES FOR LOCAL GOVERNMENTS, supra} note 233, at § 2.

\textsuperscript{94} The cost-of-carry represents the differential in the interest rate paid on a long-term loan and the interest rate received on the short-term investment of the loan proceeds.
needed rather than received as a lump sum from a bond sale. A technical assistance program will provide training and information regarding these and other issues to be faced when borrowing funds in the capital markets. A technical assistance program would also provide an opportunity for ongoing review of the uses that IAMCF funds were being put and an avenue for encouraging good governance at the sub-sovereign level.

5. Dealing with Default

The proposed IAMCF should incorporate appropriate measures to minimize the risk and potential impact of any issuer default. The World Bank has been criticized as overly aggressive in its lending practices, putting at risk the capital of its member shareholders and, ultimately, rich-country taxpayers. Theoretically, providing bond insurance should not be any riskier than taking a participating role in the underlying loan. Of course, since bond insurance funds are leveraged, the potential consequences of default are magnified. There is also some concern that lending officials might scrutinize a bond insurance application less carefully than they would a full-scale loan application.

To minimize the risk of default, the proposed IAMCF should impose strict minimum credit requirements. Commercial bond insurers typically underwrite to a “zero-loss” standard, and the proposed IAMCF should seek to do the same. It is of utmost importance that enhancement only be extended to municipal bond issues of reasonably good credit

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95. Specialized Financial Intermediaries for Local Governments, supra note 23, at ¶ 14.
97. The Asian Development Bank has attempted to address this by requiring the Bank to take a position beyond credit enhancement in the project for which a guarantee is provided. The reasoning is that this requirement will ensure proper scrutiny of creditworthiness. Asian Dev. Bank, Operations Manual, § D9, ¶ 9 (Oct. 29, 2003), available at http://www.iadb.org/Documents/Manuals/Operations/default.asp?p=policies.
98. In addition to their role in minimizing the risk of default, criteria imposed by the IAMCF to determine which municipal securities will qualify for IAMCF bond insurance will enhance the financial sophistication of local government financial officers by providing a framework for analysis. The rationalizing benefit of a criteria-based approach to credit analysis in the developing world has been referenced by the World Bank in the context of specialized financial intermediaries for municipal governments, which would act as a complement to the municipal bond markets. In a 2000 report, Samir El Daher wrote: “[I]n rationalizing the ad-hoc, arbitrary and sometimes politically guided process of resource transfers from central to local governments, the criteria-based MDF funding (relying on strong technical capabilities within the MDF) can strengthen local capacity, improve the selection of investment priorities, and markedly enhance the quality of local project finance.” Specialized Financial Intermediaries for Local Governments, supra note 23, at 2, ¶ 8. Similar benefits would likely be derived from an IAMCF criteria-based provision of bond insurance.
quality. In Latin America, where credit ratings are even lower than in most developing countries, this restriction will present a challenge.\textsuperscript{100} Although a detailed credit analysis would obviously be necessary for any transaction the proposed IAMCF planned to insure, a good starting point would be to require at least an investment grade rating on the country's local scale, by either Standard & Poor's or Moody's Investors Service.\textsuperscript{101} Of the seventy-one Latin American corporate issuers of dollar-denominated bonds that have defaulted since 1995, only seven issues "were originally rated investment grade."\textsuperscript{102} Implementing an investment grade rating requirement would thus be an important first step in minimizing the proposed IAMCF's exposure to default.

The proposed IAMCF should also take steps to minimize the potential impact of any issuer default. One such step would be the inclusion of a provision that bond debt service will not be automatically accelerated in the event of a default. The indenture of the Bond Guarantee Program of the Texas Permanent School Fund contains a similar provision.\textsuperscript{103} A similar requirement is embedded in the governing articles of the IBRD and the IDB.\textsuperscript{104} This provision is important because it increases the likelihood that a defaulting issuer will be able to recover financially and resume payments on its bonds, reducing the exposure of the guarantor.

V. CONCLUSION

The promise of a multilateral-sponsored municipal bond insurance agency for promoting infrastructure and capital markets development in Latin America is very real. Additional discussion of the concept is appropriate, particularly to ensure the inclusion of commercial actors, including the major investment banks and bond insurance agencies, in the conversation. Consensus, where possible, is always an easier path to development, and these private entities are likely to have valuable insights as to

\textsuperscript{100} See Global Development Finance 2004, supra note 26, at 43 (noting that the average rating for Latin America was the lowest of all regions and was "almost two notches below the developing-country average of Ba2").

\textsuperscript{101} See, Financial Market Development, supra note 18, at 12 (observing that, while their indications may not be perfect, the major international rating agencies can "provide good estimates of future default probabilities, and a low cost signal of creditworthiness"). Also, note that the requirement of investment grade ratings is strictly adhered to by monoline bond insurers in the domestic market. Experience of the USA, supra note 16, at 4.

\textsuperscript{102} Fitch Ratings Report, Latin American Bond Default Study 5 (July 31, 2003) (prepared by Giovanny Grosso & Samuel Fox), available at http://www. fitchratings.com (highlight Corporate Finance; follow Corporates hyperlink; then follow Special Reports hyperlink; then follow 31 Jul. 2003).

\textsuperscript{103} Bryan ISD POS, supra note 47, at 20.

\textsuperscript{104} IBRD Articles of Agreement, supra note 78, art. IV § 5(c) ("Guarantees by the Bank shall provide that the Bank may terminate its liability with respect to interest if, upon default by the borrower and by the guarantor, if any, the Bank offers to purchase, at par and interest accrued to a date designated in the offer, the bonds or other obligations guaranteed."); IBD Establishing Agreement, supra note 54, art. III § 11(b).
how an IAMCF might best serve the needs of state and local governments in Latin America.

Although there are legitimate concerns for the financial integrity of the multilateral development banks and the increased exposure of their assets to entities whose creditworthiness is marginal, remote capitalization of the program through an IDB-administered Trust Fund would provide a low-cost, efficient way of experimenting with such a program without risking the entire asset base of the multilaterals. This could be accomplished within the existing governing agreements of the IDB and the IBRD and would allow broad financial participation from all interested parties. By moving away from the current, compartmentalized approach to development, a bond insurance approach to infrastructure and capital markets development would constitute a significant step towards adopting a tools-based approach to development. By providing Latin American state and local governments with the capacity to rely on existing markets for their funding requirements, an IAMCF would encourage the independence of these entities, paving the way for their future self-sufficiency.