A helping hand

Last month the US proposed a $1 billion loan guarantee programme for Ukraine. This would significantly expand the application of the foreign assistance tool

Since the early 1990s, the US has provided loan guarantees to five foreign sovereigns, allowing those governments to issue debt securities that are fully guaranteed by the US in the global capital markets. For the sovereigns who enjoyed the benefit of these guarantees, the result was much cheaper financing than would have been available based solely on their own credit. For the US, each loan guarantee was intended to accomplish specific foreign policy goals. Sovereign loan guarantees were most recently in the spotlight as a result of the Obama administration's proposed $1 billion loan programme for Ukraine. Announced in early March, this proposal is likely to receive rapid Congressional approval.

If this programme is authorised, it will be the first use of US sovereign loan guarantees outside of the Middle Eastern and North Africa (MENA) region. To date, the only beneficiaries of US sovereign loan guarantees have been Israel, Egypt, Turkey, Tunisia and Jordan. In limiting the sovereign loan guarantees to these recipients, the US appears to have focused on countries that are of strategic importance to the US; are capable of using the guarantees to access the capital markets; can make good use of the funds raised; and that, historically, have had strong relationships with the US. Most recently, sovereign loan guarantees were provided to Tunisia and Jordan to assist those countries in their transition to democracy and economic stability. Given there are a number of other MENA countries in transition that could benefit from similar assistance, it is likely that additional sovereign loan guarantees will be provided to such countries in the future. And as the proposal for Ukrainian assistance demonstrates, there is no reason why countries in other regions could not benefit under similar programmes.

> "A Ukrainian programme would be the first use of US sovereign loan guarantees outside of the MENA region

The benefits to the countries that receive US loan guarantees can be substantial. For example, in 2012 Tunisia was able to issue $485 million in seven-year guaranteed notes at an interest rate of 1.686% – far better terms than Tunisia could possibly have achieved on its own credit. Indeed, Tunisia had not accessed the international capital markets at all for at least five years before its US-guaranteed issue. For the US, the selection of the beneficiary countries, establishment of the terms of the guarantees, and the setting of conditions to issuance are all designed to further US foreign policy interests.

While a US loan guarantee offers substantial benefits to the beneficiary country, the creation and implementation of these programmes involve unique issues and challenges. Not least of the challenges is the need for specific legislative authorisation for each programme, requiring Congress and the administration to agree on its purpose, goals and specific terms. In addition, the programme must address the impact of the guarantees on the US budget and administrative costs of implementation. For each programme, a set of regulations that detail matters such as the guarantee terms and the procedure for asserting a claim must be prepared and adopted by the US Agency for International Development (USAID), the agency responsible for administering the guarantees. In addition, the availability of the loan guarantees will affect the structuring and terms of the transaction, and the process by which they are offered and sold.

Policy goals and conditions

The requirement for Congressional authorisation means the legislative record usually provides a clear indication of the purposes and goals of each programme. The genesis of the US scheme was a $400 million housing loan guarantee authorised for Israel in 1991. The purpose of this guarantee was to assist the country in meeting the extraordinary housing and infrastructure needs resulting from the massive wave of immigrants who began arriving in Israel in the early 1990s, after the Soviet Union lifted its ban on emigration. These guarantees were issued under USAID's existing housing loan programme which, for a number of reasons, made the guarantees' implementation somewhat more cumbersome than the later sovereign loan guarantees.

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The housing loan initiative was followed by a $10 billion programme authorised for Israel in 1993, and a second Israeli loan guarantee programme for $9 billion in 1997. As a result of several extensions, this second guarantee remains available today. The 1993 Israeli programme was again in response to the costs and economic dislocation resulting from the influx of new immigrants. In the authorising legislation, Congress stated that the purpose of the loan guarantees was to assist 'Israel's extraordinary humanitarian effort to resettle and absorb immigrants into Israel from the republics of the former Soviet Union, Ethiopia and other countries.'

In 2005, guarantees were authorised for Egypt and Turkey, in maximum amounts of $2 billion and $8.5 billion, respectively. These programmes were intended, in part, to encourage cooperation with Operation Iraqi Freedom, and to 'help offset economic dislocation and hardship brought on by a conflict with Iraq.' While Egypt did make use of its US loan guarantee programme, Turkey's was never implemented.

For US fiscal years 2013 and 2014, the administration proposed a Middle East and North Africa Incentive Fund. This would have provided funds that could be used for direct grants, multilateral programmes and loan guarantees, and rapid response interventions to support security, political and economic reform and stability in the region. The proposed legislation specifically cited programmes focused on empowering women and girls, promoting scholarship and public diplomacy, as well as broadcasting and use of the Internet and social media to facility communication among the people of the region. The MENA Incentive Fund's authority was not country specific, and would have been available to any government in the region the government determined suitable. For fiscal year 2015, the administration has again requested authorisation of a regional MENA loan guarantee programme.

Congress declined to authorise the broader MENA Incentive Fund in fiscal years 2013 and 2014, but it did approve sovereign loan guarantees for Tunisia and Jordan specifically. These guarantees fulfilled, in part, commitments made by the US and other G8 countries in the 2011 Deauville Partnership with Arab Countries in Transition. This is intended to help transitioning countries in the MENA region (specifically Egypt, Libya, Jordan, Morocco and Tunisia) achieve economic and political stability. In particular, the loan guarantees for Tunisia and Jordan may be viewed as part of the Deauville Partnership's Capital Market Access Initiative which, according to the US Treasury, 'aims to help the transitioning countries reintegrate into international capital markets under reasonable financing terms.' In Jordan's case, the US guarantees were also intended to assist with the costs and economic dislocation of hosting more than half a million refugees from Syria.

The sovereign loan guarantees, however, do not come without conditions, and it is through the design and implementation of these conditions that the US seeks to accomplish its policy goals. First, virtually all programmes are conditioned on the beneficiary country's commitment to economic and budgetary reforms established in bilateral discussions. These conditions may include, for example, reduction of debt, progress toward privatisation, and energy sector reform. Second, the availability of the guarantees may be subject to conditions designed to further very specific US policy goals. For example, the Turkish legislation directed that no funds or guarantees be made available 'if the Secretary of State determines…that the Government of Turkey is not cooperating with the United States in Operation Iraqi Freedom.'

In the case of Israel, the authorising legislation provides that the amount of guarantees available in any year will be 'reduced by an amount equal to the amount extended or estimated to have been extended by the Government of Israel during the previous year for activities which the President determines are inconsistent with the objectives of this section.' This is generally understood to mean that the amount of the guarantees available may be reduced by the amounts spent by Israel for settlement activity in the occupied territories. In addition, the legislation provides that guarantees may be issued 'only to support activities in the geographic areas which were subject to the administration of the Government of Israel before June 5, 1967.'

Budget issues

Before the enactment of the Credit Reform Act of 1990, guarantees issued by the US government were off-budget. While guarantees issued during the budget year were reflected in a footnote, neither the amount of the guarantees nor the risk that payment of the guaranteed amounts might ultimately be required as a result of a default in the underlying obligation, had any direct impact on the federal budget. This meant that federal government guarantees were viewed as a cost-free way to achieve policy objectives.

However, the recession of the early 1980s, market crash of 1987, and the burgeoning savings and loan crisis of the late 1980s somewhat changed this view. These events led to a growing movement toward fiscal and budgetary responsibility, and the realisation that government-issued guarantees were real financial commitments, which carried real potential for substantial governmental expenditures. Accordingly, beginning in 1990, the Credit Reform Act required that the 'subsidy cost' of each guarantee issued by the federal government be 'scored', or reflected as an expenditure in the fiscal year of issuance. The subsidy cost is essentially a risk-based calculation, based on factors such as the amount of the guarantee, its duration and the credit-worthiness of the guaranteed debtor, much like an insurance company's calculation of an appropriate premium for assumption of a particular risk. This cost is calculated by the Office of Management and Budget (OMB), which is part of the executive office of the President. For the sovereign loan guarantees issued to date, the subsidy cost has generally ranged from approximately 2.5% to eight percent of the principal amount of the guaranteed obligations.

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Some loan guarantee programmes are required to be 'budget neutral'. This means that the sovereign has to pay a fee upon each issuance of guarantees equal to the subsidy cost to be reflected on the US budget. In other words, while budget scoring required the recording of the OMB-determined subsidy cost as an expenditure, the foreign sovereign would pay a guarantee fee of an equal amount. This meant that for US budget purposes, the fee revenues precisely offset the subsidy cost expenditure. Not coincidentally, this 'issuer pays' model was used for the largest of the loan guarantee programmes, being those provided to Israel, Egypt and Turkey. However, simultaneously with the authorisation of Egypt and Turkey's programmes, substantial grants ($300 million for Egypt and $1 billion for Turkey) were also authorised under legislation that permitted the use of the grants to pay the fees for the loan guarantees.

By contrast, in authorising the loan guarantee programmes for Tunisia and Jordan, Congress simultaneously appropriated an amount equal to the subsidy cost so the sovereign beneficiary did not have to bear the expense of scoring. Essentially, the direct appropriation of the subsidy costs permitted each country to leverage the appropriated amount by using it to cover the issuance of guarantees in an amount several times the amount of the appropriation. For example, the legislation authorising the Tunisian guarantees provided for an appropriation of $30 million, which was used to support guarantees of $485 million of sovereign bonds.

To date there have been no defaults, and the US has not been required to make any payments, under any outstanding sovereign loan guarantees programmes. Consequently, the US' only cost arising from the sovereign loan guarantees has been the subsidy cost. And where the beneficiary country has been required to pay guarantee fees equal to that cost, issuance of the guarantees has been entirely budget-neutral.

Structural issues

While US loan guarantees could be used to support individual or syndicated bank loans, all participating sovereigns to-date have turned to the international capital markets. Because the debt principal and interest are 100% guaranteed by the full faith and credit of the US, the issuance of these securities is exempt from the registration requirements of the Securities Act 1933 pursuant to section 3(a)(2). These deals are also generally exempt from registration or qualification requirements in other jurisdictions as well. This means the guaranteed securities may be sold in global public offerings without the need to register or file with, or the approval of, the US Securities and Exchange Commission or other securities authorities.

The US guarantee also means that the principal credit underlying the securities is that of the US, not the issuing country. Accordingly, the deal prospectuses do not contain the extensive economic, statistical, political and other information about the issuer that is typical of sovereign debt offerings, and the securities are generally marketed, sold and priced as if they were US agency securities.

In addition to the authorising legislation, each loan guarantee programme is governed by a set of regulations adopted by USAID. These set out the terms and conditions of the guarantees, and prescribe the procedures for submitting a claim in the event of default. To help assure securities market acceptance, the USAID regulations generally provide that claims under the guarantees will be paid within three business days of the date on which a claim is submitted by a guaranteed security holder, or by the fiscal agent on behalf of all holders of the defaulted issue. In addition, the regulations and deal terms generally provide that the securities are not subject to prepayment or acceleration, in the event of a default or otherwise. Instead, USAID is obliged to continue paying interest and principal on the defaulted securities in accordance with the original payment schedule.

Each programme is also subject to a loan guarantee commitment agreement entered into between USAID and the sovereign beneficiary. This agreement sets out, among other things, the conditions to the issuance of the guarantees. As noted above, this may include specific economic, budgetary or sectorial reforms, or other conditions consistent with the programme's policy goals. Once the conditions are met and the guarantees are actually issued, they become unconditional full faith and credit obligations of the US. They will not be impaired by any defect in the authorisation or execution of the guarantees, or the termination of the program under which they were issued.

Outlook

The sovereign loan guarantee programmes have proved an effective means of furthering US foreign policy objectives. The sovereign loan guarantees leverage a relatively small amount of subsidy costs into a much larger amount of financing proceeds for the beneficiary country, maximizing the impact of US assistance. In some cases, the sovereign loan guarantees have reintroduced the beneficiary country to the global capital markets, restoring investor confidence in the sovereign and easing the path toward self-sufficiency. Finally, the conditions to the sovereign loan guarantees encourage political, institutional and economic reforms, consistent with US political and strategic interests.

For the beneficiary countries, sovereign loan guarantees provide access to much-needed financing on highly favourable terms. They may also represent an endorsement by the US of the country's progress toward reform and demonstrate confidence in its stability and economic prospects. The loan guarantees may also constitute only one element in a larger package of assistance, and may be targeted toward objectives that other forms of assistance could not achieve.

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Consequently, we would expect to see a continuation, and most likely growth, in the availability and use of US loan guarantees. The government proposals for broad loan guarantee authority in the MENA region evidence a continuing interest in this foreign assistance tool, and while Congress has so far declined to authorise such broad authority, it has responded with additional country-specific programmes. As the Ukrainian proposal demonstrates, we would expect to see sovereign loan guarantee programmes employed outside of the MENA region…

By Arnold & Porter partner Steven G Tepper in New York