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Priming the Pump: Tapping the Global Capital Markets to Fund the World's Infrastructure Needs

Keynote Luncheon Address

*Martin Kamarck**

In the interest of full disclosure, I will begin by expanding upon a somewhat cryptic reference made earlier in the proceedings. Among the participants in this excellent program, it was said that we would be covering all the bases with respect to the players in the market place for project finance and infrastructure development. Subsequently, Ken Hansen referred to commercial insurers as being included among such players. I am one of those players. My company, Radian Asset Assurance, does not write political risk insurance directly, but we do assume a good deal of that kind of risk in one of our reinsurance product lines. In our direct business, we are primarily a financial guaranty insurer. We provide credit enhancement and credit risk management products.

Full disclosure is important for two reasons. First, many banks these days will tell you that they are not in the business of taking credit risk, but rather, of "intermediating" credit risk. Unlike these banks, understanding, underwriting, pricing, and holding credit risk are what we do. Second, as Ken delicately suggested, we are unabashedly in it for the money. While these facts obviously do not add luster to my meager credentials for inclusion in the distinguished company of speakers in this program, they may add some weight to my *bona fides* as one who takes credit seriously. If I make poor credit judgments, my family will not eat. That, as they say of the imminent prospect of the gallows, focuses the mind wonderfully.

I was struck in particular by one aspect of Professor Don Wallace's introductory remarks this morning. Exercising my keynoter prerogative and my general tendency to over simplify things, I would paraphrase Professor Wallace as saying, "Show me the money!" Similarly, we heard from Professor Michael Malloy about the costs to the commercial banking sector for funding infrastructure finance and project finance. He focused on the differential costs in terms of capital charges under the risk-based capital regime of the Basel Accord. The common thread is the significant cost to a banking institution to fund credit for infrastructure development. The cost exists regardless of whether the particular deal structure is characterized favorably under the Basel Accord as corporate lending or, more punitively, in the special lending categories, depending on the factors that Professor Malloy laid out for us.

To hark back to what Professor Wallace said, on the one hand we have a huge and pressing need for funding—cash-on-the-barrelhead money—for

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infrastructure development around the globe in the public sector and quasi-public sectors. Against that deficit or demand for funding, let us look at the potential supply of available funding and the sources of required cash. First, we can add up the total capacity of the World Bank, all of the other multilateral development banks, the Organisation for Economic Cooperation and Development ("OECD") export credit agencies, and other public sector sources of aid for development and finance. Next, on the supply side of the equation, we can add to those funding sources the capital capacity of all of the world's commercial banks. This room, so to speak, on the banks' balance sheets, is measurable with some degree of consistency and precision under the Basel rules. When we get done with this fairly straightforward exercise, we see clearly that the potential demand in the world now, and in the foreseeable future, for funding of necessary infrastructure development dwarfs all of the institutional capacity conceivably available to meet that demand.

My purpose today is not to speak to you as a representative of the financial guaranty industry by talking about credit enhancement or political risk insurance and their little niches in the project finance market place. Rather, I have the *chutzpah* to represent another party, and I presume to say the most important party, to all of these issues that we have been talking about: the Belgian dentist. That is, the proverbial Belgian dentist who buys international bond issues to fund his retirement. Investment bankers will personify their audience as this prototypical investor, the Belgian dentist, when they talk about disclosure for an international bond issue.

I am talking about the global fixed income markets: the bond markets. As Professor Wallace emphasized, there is and will be a huge demand for funding for global infrastructure development. The institutional capacities, both public and private, are simply nowhere near large enough to satisfy that demand. But the capacity of the international bond markets is literally almost infinite. Having stated that syllogism, the conclusion is inescapable: If we are serious about promoting the development of public sector infrastructure in order to meet the pressing needs of the world's peoples for healthy and productive lives, we cannot ignore the connection to the global fixed income markets. If we are to have any hope of success, the financing for infrastructure development must be attractive to the capital markets. This is really what I want to talk about today.

When I was at Ex-Im Bank I used to say commonly in my stump speeches around the country and around the world, that in contrast to other public sector agencies, the Bank's mission could be characterized in relatively simple and straightforward terms. If you tried to sum up in a sentence what the Department of Health and Human Services does, or even for that matter the Justice Department, the dependent clauses and conditionals would get pretty thick, pretty fast. By the same token, managing an agency of that size and multifariousness is commensurately difficult. I was grateful to be charged with leading a small agency with a clear mission. Our goal was to follow America's exporters into

their newest markets with the greatest potential, lead the banks and the bond investors into those markets, and then get out of the way.

Think of that dynamic as priming the money pump. The concept is very powerful and fully applicable to the theme of my talk to you today. Professor Kojo Yelpaala rightly exhorted us today that it is very important to lift our eyes and think about what our larger purpose is here. He framed the larger purpose in terms of the end goal, which is to promote economic development for the betterment of the world. I suggest to you that the bond markets are the means to that end. Therefore, as public sector employees, representatives of the multilateral development banks, engaged academics, and private facilitators of these markets, we have a responsibility. Our responsibility is to prime the pump in order to tap the unlimited capacity of the international bond markets and fund the infrastructure development that the world needs and conscience demands.

For example, we can talk about the importance of fundamental principles like the rule of law as *a priori,* important ends in themselves. However, I prefer to think about these sorts of things as means to the end of reconciling the demands we have for capital in the world with the most abundant supply of capital that the creativity of humankind has yet to conceive.

As you have listened to me so far, I anticipate two concerns. One is that I am, as I have warned you several times already, over simplifying and for that I will make no apologies. I tend to do that. There is certainly some flavor in this solution of what Professor Wallace called dumb marketism. You may also share the concern, often expressed, about the possible debilitating effects of the tidal flows of the bond markets' "hot money." This morning, Alfredo Pascual described in gory detail some of the attributes of the recently remembered Asian Debt Crisis. Also, you may well recall that one of the debates surrounding that unfortunate set of occurrences was whether or not transnational capital flows caused or were an exacerbating consequence of the crisis. There was certainly a lot of debate about whether the so-called "hot money" of bond investors—always in this context characterized as "speculators"—helped to create the problem and, perhaps, according to those who espouse this theory, made it worse.

My personal opinion is that this is a canard, demonstrably so. There is a very important kernel of truth in it to which I will return. However, it is important to put to rest the concern that the free movement of capital and of international investment in the form of the fixed income markets can be a bad thing, especially in the kinds of contexts we discussed here today and yesterday.

There is some very interesting work that was done in this regard by Professor Ken Froot at the Harvard Business School. He looked at capital flows both in terms of the data readily available from public sources, and he has also had the advantage of getting access to a remarkable trove of relevant data which is the custody information for fixed income securities of State Street Bank. This data comprises a very interesting and statistically significant cross section of the flow of money as represented by marketable securities, both publicly issued and privately placed. This makes it a particularly interesting store of information.

Professor Froot has mined a lot of interesting insights out of those data sources, but *a propos* the specific case study of the Asian Debt Crisis there is one fact that is particularly important to our purposes here today. If you separate institutional (*i.e.*, bank) lending from capital market investing flows and map them over time against the timing of the rolling crisis in Asia, you actually see that the capital market investments built up relatively slowly over time, in a gradual curve up through the peak. Most significant was a gradual and orderly reduction in amounts of new investment, and then a leveling off. In other words, the actual data exhibited no evidence of any "speculative" rush of "hot money" in or out of Asian markets over the relevant time periods. Having been active in fixed income finance of one sort or another in my career for almost thirty years, I am not surprised by these findings because the capital markets are funded for the most part via liquid securities changing hands in actively-traded markets. Consequently, the market dynamics are subject to the dampening effects from the contrarians, those very sophisticated investors who make money by moving counter to the mob. As the bubble, if you will, headed towards its peak, those investors put on the brakes and slowed down or ceased their rate of investment in those markets. Similarly, as you came down the other side, you had people who saw the opportunities arising for bargain prices in some instances. Both of those factors moderated the bubble effect that some observers claimed to see.

In marked contrast were the bank lending flows. Instead of the gentler curve up and down of capital market investment levels into the Asian markets, the bank lending flows exhibited a very sharp climb up to a stratospheric peak. They then curved precipitously down into negative territory (*i.e.*, not just a lower rate of new inward investment but actual disinvestments) as banks did what they so often brilliantly do when things start to get a little bad, which is to make it much worse by calling their loans and accelerating the principal maturities. When Professor Froot presented a slide showing the graph of this dynamic, I particularly love the headline on it, "What Kills You is Not the Speed, it is The Sudden Stop."

In other words, all of the best data that we have available suggests that it is slander to characterize the bond markets as fueled by "hot money" and to call bond investors "speculators." Furthermore, it is dangerously paranoid nonsense to imagine some dark conspiracy to exploit the vulnerabilities of the emerging market economies by building and bursting investment bubbles. There is a herd mentality in market dynamics, but history and common sense teach that the institutional lenders tend to stampede in and out of markets more precipitously and to more destructive effect than do capital market investors.

However, the grain of truth in the conventional concerns about capital markets funding is that bond investor money is not patient money. The solid foundation or starting point for any sound enterprise or project must be patient money, that is, equity or grant funding. The very first step to priming the pump for bond market funding is some baseline level of equity investment at risk. However, that component is beyond the scope of my remarks today. I am here to

talk about how to attract the next, and substantially larger, layer of debt financing for infrastructure projects from the infinite resources of the global capital markets.

So what do I mean in this context by saying that bond investor money is not patient money? I am not making the distinction between short-term and long-term funding. A lot of bond investment is for terms of up to thirty years and some are literally "perpetual." What I mean is that bond investment is, by definition, credit sensitive. Bond investors have this curious desire to get their interest and principal repaid on time. This little quirk is so important to them that, if they perceive that other bond investors have not gotten their principal and interest paid on time or have had difficulty in that arena, they will tend to be a little skeptical about issuers and deal structures of that sort for some time to come. Conversely, when particular kinds of markets, borrowers and deal structures work—*i.e.* result in payments in full and on time to investors—then those particular markets, borrowers, and deal structures tend to attract more and lower cost bond financing.

This topic is near and dear to my heart since it touches upon what I actually do for a living. Although I am a recovering lawyer, I do not think of myself in that regard. Rather, I earn my bread as a crusty old credit guy.

When Professor Frank Wang and I were baby lawyers together. Let me rephrase that: When I was a baby lawyer and Frank Wang was my wise and experienced mentor, the senior partner at our firm had a negotiating ploy that was very effective. Whenever he had to sit down across the table from New York lawyers from Shearman & Sterling or Millbank, Tweed, he would begin by saying, "Well, I'm just a country lawyer from San Francisco . . ." When he said this, we knew the discussion was about to get hot and heavy. These days, at Radian's credit committee, when I go into my "crusty old credit guy" routine, our hotshot transactors know their pet deals are about to get eviscerated.

My point here is that as a recovering lawyer, I have turned myself into a crusty old credit guy and I happen to think I am pretty good at it. There is no particular art or science to good credit. The most fundamental thing about good credit is common sense. At Radian, we are in the business of taking and holding credit risk. We employ a full complement of quants these days and they are quite the United Nations or Tower of Babel. Among our quantitative risk analysts are a stable of Ph.D.'s in nuclear physics, mathematics, statistics, and engineering, and people whose first language is Russian, Italian, Korean, and Chinese, as well as English. In addition, they all speak quant. The only way to keep ahead of these young geniuses is to hew to the simple, straight-forward common sense that it takes to have good credit. Good credit fundamentals are the only way to attract bond market funding to meet the demand for infrastructure development.

So far, throughout the conversations in this program, I can pick out three basic principles of good credit fundamentals. The first principle is that good intentions do not make good credit. From my first days negotiating term loan agreements an inevitable point in the conversation is reached where the borrower says, with hurt feelings, "but you are acting like I am not going to pay this back."

If you are going to structure a good deal you must assume that the borrower is going to have trouble of one sort or another paying it back, and you live with that risk.

When I was at Ex-Im Bank we had an excellent team working on an important deal in Kuwait and they ran into trouble on this very point. As Chairman of the Bank, I spent three weeks in Kuwait City working through this issue at the highest levels. The proposed project was a polyethylene plant and the feedstock was natural gas. The volume of natural gas produced by Kuwaiti wells is 100 percent associated with the volume of crude oil production. The more crude oil you pump the more natural gas you have. The less you pump, the less you have. All of the assumptions in performance about how this plant was going to operate devolved upon a dependable supply of a minimum quantity of natural gas feedstock. Sound credit analysis required some assurance that such a dependably minimum supply would be maintained. Unfortunately, the Kuwaitis were unwilling to provide any such formal assurance.

The Kuwaitis said, "this is supposed to be 'project finance'; we are not supposed to have to guarantee anything. It is supposed to be non-recourse." They continued along the hurt feelings line, "We really want this plant, and we want it to succeed. Why in the world would we starve it of feedstock now? What kind of people do you think we are? We are not stupid and we are not bad." My reply was the following scenario: imagine that OPEC is supremely successful at some point in the future and the price of crude goes to $120 a barrel, but only on condition that Kuwait cut back its crude oil production by seventy-five percent. Then I asked, "What would you do?" I then explained that "it would not be a stupid choice, and you would not be a bad person if you drastically cut back on production and sacrificed the viability of the polyethylene plant. In fact, you owe it to your children and grandchildren to do exactly that." A long pause followed, and my counterpart finally said, "from your mouth to Allah's ear." This scenario demonstrates that sound credit structuring is not about virtuous character or good intentions; it is about the alignment of economic interests and the appropriate allocations of risks.

The second basic principle of good credit is that you must be concerned with substance over form. In terms of the issues that we have had before us, I would highlight the rule of law. I am not talking about just buying a set of laws from "Laws R Us." In side conversations at this conference, I have noticed that people have informally expressed a great deal of skepticism about law reform in Russia. They questioned whether or not this world class set of laws that Sara Carey described will actually function as intended. We can never and should never expect legal structure, transparency, and due process to provide perfect protection from bad acts or outright fraud. However, neither should we be bemused by the trappings of the rule of law when the reality is crony capitalism, kleptocracy, or even an informal extra-legal system that exists alongside. A very interesting question is whether the Parmalat scandals are examples of fraud, event risk, or manifestations of some much deeper systematic problems in Italy's economic

and legal systems. We can debate that topic, but bond investors will make their own judgments and vote with their feet. I add editorially that Italian Prime Minister Silvio Berlusconi's efforts to immunize himself from prosecution did not help Italy's case in that regard.

Finally, the third fundamental of sound credit brings me back to where I started with Professor Yelpaala's exhortation to us to remember the big picture. This turns on what I call Kamarck's law of conservation of risk in the universe. As with energy in the realm of physics, so it is with risk in the world of commerce: you can slice it, you can dice it, you can move it around, you can make it live here for a while and there for a while. You can build elaborate infrastructures on top of the allocations of risk. But you never make risk go away; it always lives somewhere and someone will lose money if things go wrong. You would be amazed at how many very sophisticated people kid themselves in this regard. It can be as simple as saying, it is project finance, it is magic, and somehow the risk has gone away. As Professor Malloy showed in some of his hypotheticals, you can structure the allocations of risk and the nature of those risks in many different ways but they will always be there. You can say, okay, we can measure the risk in different ways and allocate capital against it by different formulas for Basel Accord purposes, but the risk is always there. The fact that you call it corporate risk rather than special lending risk does not make it go away.

That brings me to my final point. I quoted with approval, Professor Yelpaala's exhortation to us to lift our eyes from the details of what we are thinking and doing and to focus on the larger good and policy concerns. I think this is why we are all here today. We are trying to advance the state of the art, improving the development of infrastructure in the public sector around the globe, and in particular in the emerging economies. This is tremendously important. But I want to close by celebrating those of you who have interest, concern, and livelihood focused on those not necessarily glamorous details of making an individual deal work, to move the dials and the levers with respect to a particular transaction's structure so that for example my three basic rules of good credit can be observed. You are in fact advancing, in a very tangible way, our progress towards that larger goal.

Remember, for every good deal that gets done, many more dollars will become available for the next deal of that sort. It is noble work to feed the ineluctable and virtuous circle that is too little exploited to the full benefit because people get sloppy, and because people kid themselves about the common sense of credit. As a result, we get bad deals and bad press. Make no mistake, it is not easy to prime the pump of the capital markets, tap their vast capacity, and get money flowing to where it is so desperately needed to fund infrastructure. It is very easy to staunch or divert those flows if we do not do our jobs well. So, while I think it is very important to lift up our eyes and understand the larger goal that we are working towards and to talk about the bigger policy issues that are subsumed by that goal, I really want to underscore the crucial importance of the

work, the thinking that is done at the detail level, deal-by-deal, and the sound structures that get put into place so that the next deal will get done, and the next, and the next. For every Dollar or Euro that is paid back, in full and on time, many more will flow, and the next deal will be that much easier to get done in the next market and for the next need. This one-step-at-a-time process is what taps us into the huge potential of the worldwide bond market and ultimately will get us to where we want to go in terms of financing the world's urgent demands for infrastructure development.