The Role and Mission of the Overseas Private Investment Corporation

An assessment of the role and mission of the Overseas Private Investment Corporation (OPIC) necessarily must begin with the most basic question of all: What is the rationale for the presence of a public-sector agency such as OPIC in the midst of vibrant private-sector activity already helping to support the movement of US foreign direct investment (FDI) to developing countries? To explore the justification for OPIC requires a brief look at the analytics of what might justify public-sector intervention—on the basis of externalities, noneconomic social purposes, and market failures, as these pertain to OPIC.

This perspective provides a basis for judging whether private-sector actors can fulfill the same functions as OPIC on their own, and it helps in assessing some of the persistent criticisms of OPIC—namely, that because it earns a profit, it should be privatized; that because a large proportion of its revenue derives from interest earned on its reserves of US Treasury bonds, it must not be playing a socially useful role; and that because it provides much of its support to large, established corporations, it must be engaging in “corporate welfare.”

After assessing these criticisms, this chapter turns to the measures OPIC has proposed undertaking to ensure that its operations complement rather than compete with the private sector to the greatest extent possible. These new “additionality” initiatives raise questions about OPIC’s ability to remain self-sustaining, due to adverse selection among the projects it may be able to support and due to constriction of its ability to diversify its portfolio of exposures. The chapter concludes with a discussion of how these additionality initiatives might have potentially anticompetitive side effects.
The Analytics of Public-Sector Intervention in Private Markets

The political risk insurance and guarantee industry has changed dramatically during the past decade and a half. Fifteen years ago, the number of private political risk insurers was small, their capacity was limited, and the maximum period of coverage for expropriation or for contract frustration, for example, averaged no more than 3 years. Project finance, structured finance, and securitization were in their infancy. Few investment funds or venture capital funds were prepared to invest in new companies in emerging markets.

Although the events of September 11, 2001, are provoking fundamental reassessments about exposure to risk around the world, there are today many more private-sector players involved in providing political risk insurance and in funding various kinds of projects in developing countries than before. What might be the justification for the continuing presence of a government-backed agency such as OPIC in the midst of this imaginative and diverse private-sector activity that has grown up over the years?

OPIC has received sophisticated public policy criticism over the years—and doubtless will in the future. It is necessary, therefore, to review the analytics of public-sector intervention in private markets, and to explore how the possible rationales for public-sector intervention might relate to a “developmental mission” for OPIC.

There are two rationales that might justify public-sector intervention to provide political risk insurance, or loans and financial guarantees, to foreign direct investors. By extension, these two rationales might justify loans to create publicly supported equity capital funds in emerging markets.

The first rationale is that FDI in the developing world generates externalities for the United States and/or for the recipient countries—that is, economic, social, and political returns higher than what can be captured by the foreign investors themselves. The inability of foreign direct investors to appropriate all FDI benefits for themselves leads them to engage in suboptimal levels of offshore activity in comparison with what would maximize those economic, social, and political returns. The second rationale is that there may be other public purposes—such as national security objectives or other foreign policy goals—that can be secured through the intervention of the public sector.

What empirical support is there for the first rationale—for the contention that FDI generates economic, social, and political returns greater than what can be captured by the investors themselves? Where do possible economic, social, and political externalities show up, and whom do they benefit? How does the evidence about economic, social, and political externalities support a “developmental role” for OPIC?
Economic Returns and Economic, Social, and Political Externalities for Home and Host Countries

Three bodies of literature attempt to measure FDI’s economic returns and to identify the economic, social, and political externalities that it might generate. The first examines the direct benefits to the home country (in this case to the United States) that derive from the outward investment. The second examines the benefits for the developing countries where foreign investors set up operations. The third examines the feedback loop of benefits to the home country (i.e., the United States) that derive from the enhanced economic activity in the developing world. The results of all three fit together in a way that reinforces the original aim of those who created OPIC with the objective of enhancing the growth of less developed countries.

Looking first at the economic and social benefits that accrue to the United States from the process of outward investment itself, the evidence paints a consistent picture quite at odds with much conventional wisdom. In contrast to the popular notion of a “great sucking sound”—made famous by Ross Perot—caused by multinational investors exporting jobs rather than products and undermining workers and communities in the home country, outward investment from the United States in the aggregate actually enhances the export performance of the home-based firms that make the investment and reinforces the earnings and stability of jobs in globally engaged communities.¹

This overall positive relationship between outward investment and exports from the home market holds for international investors that are establishing distribution networks abroad, for international investors that are shipping intermediate products for assembly abroad, and for international investors that are shipping final products for sale abroad. Moreover, the strength of the complementarity between outward investment and enhanced exports is large enough to more than offset exports from the investors’ foreign affiliates to third countries. The link between outward investment and expanded exports and better jobs at home holds for firms setting up operations in developing as well as developed countries.

Because export-related jobs pay wages 9 to 23 percent higher than non-export-related jobs, and offer 11 to 40 percent higher benefits, outward investment improves the composition of the labor market—that is, the proportion of good jobs relative to bad jobs—in the United States (Lewis and Richardson 2001). The strengthening of the job base at home via the connection between FDI and export performance benefits unionized workers

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¹ For a pioneering early study of the relationship between outward investment and exports, see Bergsten, Horst, and Moran (1978, chapter 3). For a recent summary of subsequent evidence, see Lipsey, Ramsterrer, and Blomstrom (2000) and Wada and Graham (2000).
as well as nonunionized workers. To sustain higher levels of wages and benefits, US firms that invest abroad use frontier production processes in their home-country plants more frequently, have higher levels of worker productivity, and enjoy more rapid growth rates of overall productivity than US firms that do not (Doms and Jensen 1998).

Those communities in the home country that serve as a base for US firms that invest abroad enjoy a higher level of economic well-being (even after controlling for size of city and geographical location) than communities that are less globally engaged. Some of this superior economic well-being can be traced directly to the more highly paid workers and managers in the multinational companies. The Eastman Kodak Corporation, for example, has had a strongly positive impact on the economic health of Rochester and Denver, which have achieved the status of 30th and 67th export cities in the United States, respectively, due in part to Kodak’s presence. But the social value of the export- and investment-related activities is larger than the benefits that can be captured by the international firms like Kodak in these cities. There are additional measurable externalities that take the form of productivity spillovers to other unrelated companies in the same community.

It is important to note that the relationship between outward investment and increased exports from the home country is a statistical relationship that holds across all home countries (in Europe, North America, and Japan), independent of whether OPIC or a comparable official political risk insurance agency is involved in any given project. Enhanced exports are a derivative benefit that accompanies the outward investment process, not a result of providing export assistance.

This distinction is significant because OPIC, unlike the US Export-Import Bank and similar official agencies in other countries, does not provide export credits. The use of such credits, which is considered “tied aid,” is governed by the OECD Arrangement on Guidelines for Officially Supported Export Credits. The OECD Arrangement is designed to control financial subsidies provided by export credit agencies through guidelines about financial terms and conditions. Because OPIC’s support is not considered tied aid, OPIC is not subject to the OECD Arrangement.

This means OPIC cannot condition its support of a project on the expectation of US exports. Although OPIC can and does collect and report data on exports generated from projects, projects do not qualify for its support on the basis of the expectation of a US export benefit.

It is also important to note that the collectively positive correlation between outward investment and enhanced exports and better jobs does not necessarily occur in each and every case. Chapter 2 will identify a new measurement criterion that OPIC should adopt to separate out projects that have a positive impact on the US home economy from those that do not.

18 REFORMING OPIC FOR THE 21st CENTURY
Turning to the economic and social benefits of foreign investor activity for recipient countries, some aggregate measurements show FDI having a significant positive impact on developing-country growth rates. Borensztein, De Gregorio, and Lee (1998), for example, examined FDI flows from industrialized countries to 69 developing countries during the past two decades.\(^2\) They found that the foreign investment projects both had higher productivity and contributed relatively more to host-country growth than domestic investment and also acted as an important vehicle for the transfer of technology. When measurements of the relationship between foreign investment and recipient-country growth rates have been lagged to avoid the possibility that higher foreign investment inflows and higher growth rates are independently attributable to some third variable (e.g., sound macroeconomic policy), the contribution of foreign investment has remained clearly visible (Lipsey 2000).

Those using other aggregate measurements are more skeptical that FDI by itself has a strong independent impact on host-country growth (Carkovic and Levine 2002). Balasubramanyam, Salisu, and Dapsoford (1996) emphasize, for example, that trade openness is crucial for obtaining the growth effects of FDI.

On a project-by-project basis, FDI in natural resources and infrastructure often shows the most immediate impact on host-country balance of payments, on host-country budgetary capacity, and on the provision of host-country services essential to sustained economic growth.\(^3\) But case studies of appropriately structured industrial and agribusiness investment demonstrate a positive relationship as well. In sectors such as petrochemicals, computers, electronics, and transportation equipment, careful measurements of the economic and social return from FDI identify externalities that come from the transfer of technology, best business practices, and quality control procedures, from export coaching, and from the movement of managers and workers from foreign subsidiaries to host-country firms.\(^4\)

But individual FDI projects do not always have a positive impact on host-country development. If foreign investor operations take place in highly protected markets, are required to meet high domestic-content requirements, or are otherwise cushioned from competitive pressures, they may not contribute to sustained economic growth.

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2. They found that the likelihood that FDI could contribute significantly to host-country growth was linked to the absorptive capacity of human capital in the domestic economy.

3. See Irwin et al. (1997). Natural resource abundance by itself, however, is not necessarily a good predictor of strong economic performance. Sachs and Warner (1995) examined 97 countries from 1971 to 1989 and found that growth was higher among less-endowed countries than among those better endowed with natural resources.

4. For a summary of contemporary evidence of externalities across industries, see Moran (2001) and Aitken, Hanson, and Harrison (1998).
these operations may detract from local economic welfare. They may also operate with harmful worker, management, gender, and health and safety practices. Chapter 2 specifies how OPIC will have to establish new screening techniques to prevent support for economically or socially damaging projects, as well as for projects that fail to adhere to internationally recognized environmental and labor standards or that engage in corrupt practices.

For projects that pass the economic development tests elaborated on in chapter 2, modern growth theory—in particular, “endogenous growth theory”—produces positive measurements of FDI’s impact that are substantially greater than conventional estimates had suggested (Romer 1992, 1994). Traditional models of economic growth had assumed that FDI’s largest contribution came from inputs of capital, with the largest benefits taking the form of employment of low-skilled labor. Newer models highlight the fact that foreign investors bring “packages” of technology, management, quality control procedures, and human resource practices that are potentially able to place host-country operations on the cutting edge of international industry. The result is not simply that the country performs those activities already present in the local economy more efficiently; rather, the country can engage in entirely new realms of economic activity.

Costa Rica provides an illustrative example of how FDI can transform the development profile of a host country. Twenty years ago, helped by a first wave of FDI, Costa Rica specialized in coffee and bananas. Ten years ago, bolstered by a second wave of FDI, it specialized in coffee, bananas, garments, and footwear. Today, reinforced by a third wave of FDI, it specializes in coffee, bananas, garments, footwear, microprocessors, medical equipment, electronic devices, data processing, and business services, generating more than $3 billion a year in exports and allowing it to surpass Chile as the most export-intensive country per capita in Latin America.

A richer appreciation of this package of technology, management, quality control, and other superior business practices leads endogenous growth theorists to predict positive contributions from FDI—and accompanying trade liberalization—on the order of 10 to 20 times greater than conventional estimates.

Moreover, the beneficial impact of FDI is likely to be greater still when foreign firms set up plants in industries where there are increasing returns to scale (Lopez-de-Silanes, Markusen, and Rutherford 1994; Markusen, Rutherford, and Hunter 1995). Modern estimation techniques—involving computable general equilibrium models, in which foreign investors

5. For evidence that FDI under noncompetitive conditions can undermine host-country growth, see Encarnation and Wells (1986). Failure to control for domestic-content requirements and other protective measures has led to the mistaken conclusion that FDI does not generate externalities for the host economy. See Haddad and Harrison (1993) and Harrison (1996).
rationalize production across borders so as to allow the firms to capture all economies of scale—yield benefits 12 times larger than when markets remain segmented, benefits that are divided between home and host country. Finally, investments that pass the “sustainable development” tests proposed in chapter 2 may generate social spillovers and externalities, and spur policy reforms, that extend well beyond the economic contribution of the individual projects.

The feedback loop from enhanced economic growth in the developing world to social and political returns for the foreign investors’ home country has several tracks. The enhanced growth among developing countries that are recipients of FDI returns economic benefits to the United States through the increment of US exports to those countries and through the increment of profits from US firms located in those countries, as well as through regional effects on export levels and profit levels of US firms.

Moving beyond beneficial economic feedback, there is a robust correlation between economic development and the process of democratization (Barro 1997; Przeworsky and Limongi 1997; Huntington 1991). Rising GDP per capita and the consequent lengthening of life expectancy are highly significant predictors of civil liberties and political rights, as measured by Freedom House. It is important to point out, however, that this empirical generalization does not mean that enhanced economic growth produces democratic institutions or respect for human rights in each and every instance, reinforcing the argument in chapter 2 in favor of case-by-case analysis about whether to permit OPIC to operate in particular countries.

Even more expansively, there is some empirical support for the observation that the spread of democracy is likely to reduce the probability of conflict within the international system. In particular, democracies have a low likelihood of waging war against each other, although whether this generalization holds in all historical periods is the subject of scholarly contention (Russett 1994; Gowa 1999). Thus, not only are there multiple lines of empirical analysis indicating that the economic, social, and political returns from fostering certain kinds of FDI are greater than the purely private returns to the companies involved, but the evidence shows that there can be a virtuous cycle of beneficial impact on both industrialized and developing countries.

Turning to the second rationale for public-sector intervention to promote FDI, the “public purposes” of a foreign policy nature are comparatively straightforward. OPIC has been a leading policy tool for the US government in crisis areas in need of economic growth and reconstruction, such as Eastern Europe and Central America in the late 1980s and early 1990s; Bosnia, Croatia, Albania, and Yugoslavia in the late 1990s; and Pakistan and Afghanistan more recently. Here the feedback loop of benefits to the United States—via promoting regional stability, or preventing terrorism or genocide, for example—may parallel but be quite distinct from enhancing the social and economic returns from the endeavor.
The evidence introduced thus far suggests that there is a rigorous public policy rationale for public-sector intervention to promote FDI, on a selective basis, in developing countries. But this does not necessarily justify the operations of an agency such as OPIC as the appropriate vehicle for trying to enhance US flows of FDI, unless there is some kind of market failure hindering FDI that OPIC is institutionally well equipped to help correct.

**OPIC and the Effort to Correct Market Failure**

To what extent might there be a market failure—inhibiting the flow of FDI to developing countries—of a kind that OPIC has the potential to help overcome? The list of factors that international companies report as impediments to undertaking FDI is long and varied. This list invariably includes unfavorable economic conditions, such as high inflation rates and weak currencies, as well as poor infrastructure, lack of transparency, corruption, and political instability. Sometimes political violence is a factor. Consistently ranking high on the list in the contemporary period—now that the likelihood of nationalization and expropriation has fallen dramatically (Minor 1994)—is the category of breach of contract or contract frustration (sometimes conceptualized as creeping expropriation, although the endpoint today has a low probability of being complete nationalization).

Given the events of September 11, 2001, political violence is clearly one kind of risk that OPIC can help to cover. So may be currency convertibility. Chapter 3 of this study discusses OPIC’s coverage of political violence and terrorism, and of currency problems. Neither of these involves market failure, strictly speaking.

Breach of contract or contract frustration (and the associated idea of creeping expropriation) do, however, fit under the rubric of market failure. Early efforts to understand developing-country propensities to violate contracts that they have signed with foreign investors—to raise tax rates, to change accounting rules (e.g., accelerated depreciation or expensing provisions that seriously affect the profitability of foreign investor operations), or to alter regulatory agreements and procedures—attributed such outcomes simply to “opportunistic” behavior on the part of nationalist or populist host-country authorities.

But if opportunistic behavior alone were able to explain the tightening of investment regulations, the fact that such behavior chokes off new investment and leads to systematic underinvestment from what would be socially optimal for the living standards and growth prospects for the countries involved might self-correct without the need for intervention in the workings of private markets. The persistence of such phenomena related to breach of contract, however, has led to the development of the
“obsolescing-bargain” model of the evolution of the business-government relationship that goes well beyond random opportunism on the part of host-country authorities.6

In the obsolescing-bargain model, changes in the level of commercial risk associated with a given project, and changes in the evaluation of the unique benefits investors bring, drive both sides toward an unstable relationship. Investors (and their financial backers) will not commit resources to a project unless those resources receive compensation commensurate with the initial uncertainties to which the resources are exposed. For any given project, the investors cannot avoid demanding generous terms when the initial risk and uncertainty are high; they cannot avoid asking that potential winners pay for potential losers across their entire portfolio of projects.

Host countries agree to these terms in order to attract the investment, but once the project is successful they (or their successors) do not want to compensate investors with the same generosity long after the initial risk and uncertainty have dissipated; they (or their successors) do not want the returns from projects in their country to make up for the parent company’s failures elsewhere. Host governments therefore are highly prone to demand that the terms of the investment agreement be revised.

The result is a strong propensity for renegotiation of investment agreements and tightening of operating conditions. If the host authorities who entered into the original investment agreements do not engage in this behavior, subsequent governments may. As a result, the original signers of foreign investment agreements cannot credibly promise that the contract will be honored. The obsolescing bargain represents a classic example of market failure due to imperfect contracts.

“Pioneer projects” and “first movers” are particularly prone to the dynamics of the obsolescing bargain, but later investors are subject to the same process as well. This is especially true if the projects involve large fixed investments and long payback periods—precisely the kinds of projects, paradoxically (and perversely), that are likely to generate substantial externalities for the host economy.

Credibility in honoring commitments is the centerpiece of being able to engage in strategic negotiations. Lack of credibility is sufficiently costly that strategic negotiators across many fields of human endeavor—including nuclear arms negotiations—seek out external mechanisms to demonstrate that they have bound their own hands (and the hands of their successors) to enforce their own promises (Schelling 1966; Williamson 1985). In the absence of such credibility, the ability to negotiate mutually beneficial agreements falls far short of what is socially optimal.

6. The phrase “obsolescing bargain” originated with Vernon (1971). For a recent summary of the use of this model of the evolution of the business-government relationship in developing countries, see Moran (1998, chapter 9).
In bargaining theory, actors may exchange hostages to enhance the credibility of their commitments, or they may deliberately leave high-value assets at risk to adverse action by the other side (as in “mutual assured destruction”), or they may provide an extended warranty (“promise to fix”) with assets in escrow to cover possible repair costs. The decision of a host country to sign an agreement with OPIC, and to allow OPIC to participate in potentially sensitive projects, can be conceptualized as a willingness to leave high-value assets at risk to action by the other side in response to the breaking of an agreement by the host, or as a willingness to provide a lengthy promise to fix.

This analysis helps put the role that OPIC can play—distinct from the role of private political risk insurers and financial guarantors—into perspective. OPIC offers the possibility of acting as the “external constraint” that helps ensure the credibility of commitments.

Whereas private insurers can provide the prospect of compensation to their clients, OPIC can provide deterrence as well as compensation. That is, OPIC’s participation in a project may help dissuade a host government from taking adverse actions toward foreign investors because the host wishes to remain on good terms with the United States and with the multiple agencies that constitute the relationship (Department of State, Department of Defense, Agency for International Development, US Export-Import Bank, etc.). In this process, OPIC’s “advocacy” efforts on behalf of clients need not be confrontational but can often take the form of behind-the-scenes mediation that quietly heads off an investment dispute before events get out of hand.

In an Asian country in 2000–01, for example, OPIC reported that a US investor that had been awarded a 25-year concession to manage the water and sewage system became involved in a rate dispute with the state-owned water utility. After obtaining an arbitral award in its favor allowing a rate increase, the company found the local regulatory agency seeking judicial intervention to block implementation of the award. An OPIC letter to the Ministry of Finance and other concerned agencies led the regulators to withdraw the legal challenge to the arbitral award and to grant a provisional tariff increase to the investor.

OPIC’s “umbrella” of protection, advocacy, and mediation provides a kind of comfort to investors, lenders, and even to other political risk insurers that cannot be replicated by the private sector (or cannot be replicated with comparable clout).

The Analytics of Public-Sector Intervention and Recurrent Criticisms of OPIC

The questioning about the rationale for OPIC’s existence as a US government–supported agency, however, does not end with abstract theoretical
debate about public intervention in private markets. Other serious considerations need to be addressed to justify how OPIC might continue to operate in the future.  

**Privatization of OPIC?**

Since its inception, OPIC has managed to generate profits that far exceed the claims that it has had to pay out, resulting in the accumulation of more than $4 billion in reserves. This has prompted some critics to assert that because OPIC can earn a profit, or operate without a loss, it should be privatized.

But the rationale for public-sector intervention—as outlined above—rests on the identification of externalities, noneconomic social purposes, and market failure, and it is quite independent of whether the activity can generate profits. The examples of public support for both research and development (R&D) and vocational education help illustrate this distinction.

Private companies gain a significant internal return from their own expenditures on R&D. But the social return from R&D spending has been consistently shown to be higher than the private returns, meaning that firms nonetheless invest less in R&D than what would be socially optimal (Mowery 1994). Private-sector activity leaves gaps, moreover, in socially important areas of research where private firms’ ability to commercialize discoveries may be weak. The result is a rigorous justification for public intervention—whether in the form of support for the National Institutes of Health, the Advanced Research Projects Agency of the Defense Department, or the R&D tax credit—even though the activity of engaging in R&D may be quite profitable.

Similarly, private companies gain a significant internal return from their own expenditures in upgrading the technical skills of their employees, with a productivity gain on the order of 16 percent (Lynch 1999). Despite the fact that corporate expenditures to enhance the skills of their workforce increase the profitability of their operations, however, aggressive recruiting on the part of rival firms and job-hopping on the part of workers who leave after they have received training prevent firms from engaging in the socially optimal amount of vocational training. This has led many public policy analysts to argue that the government would be justified in providing

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a use-it-or-lose-it tax credit to firms to induce them to augment their expenditures on training, as is done in some European countries.

In both of these comparisons, private firms can earn a profit from undertaking the socially beneficial activity. But the presence of externalities and the existence of market failures that prevent the firms from capturing all of the benefits from their expenditures provide a rigorous justification for public intervention.

The ability of OPIC to make up for the failure of many host governments to write credible long-term contracts—a function that the private sector cannot fulfill on its own—was highlighted in a study undertaken by JP Morgan in 1996, at OPIC’s request, to analyze the feasibility of privatizing OPIC (JP Morgan 1996). To the surprise of some who proposed the study, JP Morgan concluded that “a clean outright privatization of OPIC is not a viable alternative.” The key to OPIC’s success, in JP Morgan’s assessment, was its “exceptional” record of managing claims and recoveries, based to a large extent on its sway as an agency of the United States government. With developing-country authorities and their successors eager to maintain an amicable relationship with the various agencies of the US government, OPIC has enjoyed a recovery rate of 94 percent on 261 claims totaling $783 million (as of the first half of 2002).

Without official backing from the US government, observed the JP Morgan study, a new, hypothetically privatized OPIC would have difficulty selling its current product lines, and it would likely eliminate products other than those already present in the private market (e.g., ending the 20-year term on insurance policies and the coverage of projects in very high risk jurisdictions). A hypothetical buyer would surely value OPIC’s business at a discount to its current book value, noted the JP Morgan analysis, because the new entity could not hope to match OPIC’s superior recovery rate—leading to a net cost to the federal budget.

“At a minimum,” the study pointed out, a hypothetically privatized OPIC would need to be supported by the full faith and credit of the US government for all insurance policies and finance contracts currently in effect, by full indemnity to the new entity as to the adequacy of current OPIC reserves, and by maintenance of existing US government bilateral and currency salvage agreements. The private sector would not be able to reproduce on its own the “umbrella” of protection generated by US government backing.

**OPIC Profits from US Treasury Holdings?**

A second criticism is sometimes made that OPIC must not be playing much of a socially useful role because most of its profits derive not from current business but from income paid by the US government on the large reserves OPIC keeps in US government securities. But as JP Morgan stated in its report on the feasibility of privatizing OPIC, all insurance
companies typically derive the bulk of their profits from the returns on their accumulated reserves.

Thus it would be surprising, and distressing, if OPIC did not customarily derive a large proportion of its revenues from the return on the reserves it had built up. The JP Morgan study observed, moreover, that OPIC’s profits would have been much higher over time if it could have invested its reserves in a financially rational manner via a diversified portfolio of securities, instead of being artificially required to maintain them in US government bonds.

**OPIC and “Too Much” Attention to Large Investors?**

For more than three decades, the majority of OPIC projects—whether measured by numbers of contracts or amounts of coverage and guarantees—have gone to established large US firms. Has OPIC been offering “too great” a share of its services to large corporations? What is the appropriate amount of OPIC support for large investors?

The evaluation of this criticism hinges on what kinds of corporations provide the greatest externalities, fill in market failures most adequately, and/or serve public purposes (including meeting foreign policy objectives) most effectively. If Fortune 500 companies are best able to lay pipelines, build power supplies, create international production chains for manufactured products, manage integrated tourist complexes, and pioneer long-term mortgage markets—generating externalities and serving public purposes in the process—then OPIC should rightly be dealing with investors of significant size.

Conversely, if large externalities are generated by smaller firms moving from exporting to investing, or by pioneering equity funds that provide capital and demonstrate good business, labor, and environmental practices to dozens of small enterprises in emerging markets, there is rigorous justification for OPIC to be involved in this kind of activity as well.

The answer to what kinds and sizes of firms OPIC should support is an empirical one that will be dealt with more thoroughly in chapters 2 and 3, along with recommendations as to how OPIC might best expand its client base among small and medium-sized enterprises. But there is no basis for asserting that offering OPIC services to larger corporations is inappropriate per se, or constitutes some kind of “corporate welfare” because the firms are large, capable, and experienced in international markets.

**Maximizing Cooperation and Minimizing Competition with the Private Sector**

Despite a rigorous justification for OPIC’s role in enhancing the flow of FDI to developing countries, there are legitimate concerns that OPIC could
take business unfairly away from private-sector insurers and lenders. OPIC’s backing by the full faith and credit of the US government, its ability to mobilize official representation on behalf of its clients and thus enjoy a superior claims recovery record, and its tax-exempt status raise the possibility that it could underprice private-sector insurers or lenders, thereby squeezing them out of opportunities that private markets would otherwise handle on their own.

How can OPIC maximize cooperation, minimize competition, and avoid taking business away from private-sector insurers and lenders? Looking first at the pricing of insurance, OPIC’s insurance pricing sheet establishes a premium rate range by industry and customer category, and then determines the final rate after considering project-specific, country-specific, and client- and project-sponsor-specific risk factors. OPIC also adjusts the rate to reflect demand for coverage and capacity in the country, country diversification, and coverage diversification.

There are several reasons why it is difficult to compare OPIC and private-sector insurers. OPIC prices every project separately, for example, because each of its covered projects must meet environmental, labor, and US jobs criteria. It does not provide global policies across bundles of exposure. Private-sector insurers, in contrast, may provide global policies and give a portfolio discount. Private insurers may also establish a price based on offering multiple kinds of insurance services to a client (e.g., casualty or property insurance as well as political risk insurance), and perhaps based on other business relationships that a particular client brings to the insurer.

Private insurers do not make the rates they actually charge clients public. To the extent that OPIC has been able to gather comparable pricing samples, its Insurance Department reports that its insurance rates tend to be lower than those of the private sector in high-risk markets and higher in low-risk markets (in part due to the fact that there is less vigorous competition among private insurers in the former and more vigorous competition among private insurers in the latter). Investors that use both OPIC and private political risk insurers have confirmed this generalization on the basis of their own experience.

An external study commissioned from Berry, Palmer & Lyle, of London (1998, 5), concluded that “in many cases OPIC’s premiums are higher than the private market and there have been a number of examples where OPIC has lost business to the private market due to price.” The study also noted that “a review of the premium rating practices of OPIC’s OECD public sector investment insurance counterparts suggests that in general OPIC’s premium rates are high relative to those of its official counterparts in other major OECD countries” (Berry, Palmer & Lyle 1998, 4).

In addition, the paperwork associated with OPIC’s reporting requirements about environmental, labor, and US jobs effects make its policies
more cumbersome and time consuming than those of the private sector. Therefore, the concern that OPIC may systematically underprice its insurance coverage to take business away from the private sector does not appear supported by the data.

Turning next to the pricing of finance, the full faith and credit of the US government gives OPIC an edge in comparison with private-sector financial institutions. For this reason, OPIC’s Finance Department limits its operations to longer maturities, or to high-risk regions and projects, where private lenders are not prepared to participate. In both Costa Rica and Jordan, for example, OPIC helped for more than a year to put together projects and then backed off from participating when the private sector showed itself willing to carry out the financing without OPIC support.

The risk margin that OPIC charges to borrowers is determined on a case-by-case basis as a function of risks associated with a government and its economy, with the borrower’s commercial operation, and with the structure of the transaction, collateral value, and enforceability of collateral pledges. For the markets in which OPIC provides finance, however, there is typically very little pricing information available at all, and generally no pricing information that is directly comparable to the type of financing OPIC provides (i.e., long-term project financing secured primarily by the assets of the individual project).

Over the years, the principal concern about competition with the private market has centered on OPIC’s political risk insurance rather than finance. To ensure that OPIC’s political risk insurance operations provide additionality to a given project—that is, support “extra” flows of FDI that would not take place but for OPIC participation—OPIC revised its basic application for political risk investment insurance in 2001–02. The revised application advises clients that

OPIC strongly encourages Investors to consider carefully the availability of private political risk insurance for their investment abroad. OPIC only offers insurance to Investors who, having investigated the possibility of obtaining insurance from private political risk insurers, decide to pursue OPIC insurance because private insurance is not available on terms sufficient to make the investment viable for the Investor, or because of specific benefits OPIC participation will bring to the investment.

The revised application requires investors to indicate whether or not they have sought political risk insurance from private carriers, naming the American International Group (AIG), Chubb, Lloyd’s, Sovereign, and Zurich as examples; to report whether insurance is available from private political risk insurers; to name at least two private political risk insurers that have been approached; to indicate whether the insurance amount and terms are sufficient for the project’s viability; and, if private coverage is available, to explain why OPIC insurance is being sought.
This additionality initiative has provoked some controversy between private political risk insurers and longtime OPIC clients. The key area of contention has centered on what OPIC should do if clients report that coverage is not adequate due to tenor, type of coverage, or price—should OPIC accept their business or turn it down unless the potential investors agree to co insure with private suppliers?

From the point of view of the private insurers, it is not unreasonable to expect that the clients will often report that they do not find anything in the private market to match OPIC’s terms simply because OPIC enjoys the lowest cost of capital and deploys the political clout of the US government to pursue recovery, without the need to pay taxes or earn a competitive rate of return. A system that merely requires the client to “check the box” that the client tried and failed to find satisfactory coverage in the private sector—from the perspective of private insurers—is sure to allow OPIC to take business away from private suppliers.

From the point of view of investors, a system that forces them to rely purely on the private market leaves them exposed to market imperfections such as the obsolescing bargain examined above (which is why many corporate boards of directors insist upon participation by OPIC or another multilateral agency). A system that forces them to co insure with private suppliers may not enable them to secure the complete kinds of coverage that they feel they need, and it may expose them to price gouging because the number of private suppliers is not large.

In the experience of one large energy investor, for example, OPIC rates were 1.5 percent of the amount of annual coverage for an infrastructure project in Asia, in contrast to rates of 2.5 percent from the two US private insurers. The private insurers’ policies, moreover, excluded government payment risk (a crucial element for the investor’s board). After going back to try again to arrange coverage from the two US private insurers—at OPIC’s urging—the investor managed to get the two US providers down to 2.25 percent, still with the carve-out of government payment risk. The investor concluded that the private insurers left them with overly expensive rates for inadequate coverage.

Trying to second-guess the assertions of both investors and private insurers is sure to be a difficult task for OPIC. For example, OPIC could adopt a rule of thumb that it will not consider an investor’s claim to need it rather than private-sector coverage to be valid—and it will therefore refuse to offer to insure the investor—if the only difference between what OPIC and private insurers offer is a variation in price. But the investor may respond that its board requires the comfort that OPIC participation provides as part of a corporate calculus in which price is only one of many considerations, and that OPIC has no business passing judgment on the deliberations of private company boards.

Conversely, OPIC could adopt a rule of thumb that it will not consider a private insurer’s claim that the insurer is engaging in competitive pricing
for a particular project to be valid—and OPIC will therefore go ahead and offer to insure the project—if the price is more than 0.5 percent over OPIC’s own rate for a given project. But the private insurer may respond that the concentration of exposure within the insurer’s own portfolio requires a higher premium rate, and that OPIC has no business passing judgment on private prudential rules for price determination.

Trying to verify the assertions of both investors and private insurers is likely to be even more troublesome. For OPIC to adopt a practice of requiring potential clients to divulge what prices private insurers are quoting to them, and then to go back to private insurers to double-check what prices are available, for example, is sure to arouse concerns about collusive and anticompetitive behavior on the part of OPIC itself. Investors have threatened to take OPIC to the Federal Trade Commission or to the Justice Department at the first indication that OPIC is gathering price information for a particular project from other insurers.

One approach for OPIC would be to insist that clients take on private coverage up to the point where the investors walk away from the deal. The aim would be to limit OPIC’s involvement to that “wedge” of projects that would not move ahead “but for” its participation. In practice, this approach would likely mean that clients would simply stop bringing much of their business to OPIC. This approach would be aimed at minimizing competition with the private sector, but with the possible consequence of hindering the flow of FDI for development (and of shifting rents to private insurers).

A second approach for OPIC would be to urge clients to take on private coverage but to leave the ultimate discretion for structuring their coverage to the clients, especially if the client were experienced and sophisticated about managing risks. The aim would be to give private investors some freedom to draw on OPIC’s comparative advantages and unique attributes when they found private insurance coverage lacking in some respect. This approach would be aimed at maximizing OPIC’s potential to catalyze FDI for development, with the possible consequence of not eliminating all competition with private insurers.

In comparing these two approaches, it appears inevitable that there will be some residual conflict between fulfilling OPIC’s development mandate and fulfilling its mandate not to compete with the private sector. The key decision for OPIC is how to behave toward the difficult projects “at the margin” that would not come to fruition if OPIC were to insist upon private-sector participation when the investor found private terms too constrained or costly.

On the one hand, giving the benefit of the doubt to requiring private insurer participation would fit best with the goal of minimizing competition between OPIC and private insurers. On the other, giving the benefit of the doubt to investors by allowing them to choose their own combination of public and private insurers would fit best with the goal of maximizing OPIC’s ability to mobilize FDI on behalf of development.
A US government preference to highlight the developmental mission of OPIC would point toward giving the benefit of the doubt to private investors. The absence of a highly competitive market on the supplier side of political risk insurers would point in the same direction.

In consultation with the Private Market Advisory Group for Insurance, OPIC produced a set of cooperative protocols between OPIC and the private sector in 2002. These protocols require OPIC insurance officers to supply potential customers with the names and contact information for AIG, Chubb, and Zurich, as well as for Aon, Marsh, and Willis, should they want a broker. OPIC insurance officers indicate that at least two attempts should be made to contact private insurers about each project, or one attempt to contact a private broker.

If private market placement or interest fails or is insufficient, OPIC will then consider insuring the entire amount requested. First, however, OPIC will ask the client the reason(s) for the failure. If the reason seems contrary to OPIC’s understanding of the market, OPIC will ask permission to overcome the failure through checking with the three US carriers. At the end of the day, OPIC concluded that “a determination of failure or insufficiency is within the sole discretion of the client and includes failure/insufficiency of terms, conditions, rates, tenor.”

Thus in the most difficult cases, OPIC has left open the option of providing coverage if the client feels this is necessary, appropriately giving precedence thereby to its developmental mission while minimizing but not necessarily totally eliminating potential competition with private-sector insurers.

With the same objective in mind, the OPIC Finance Department has drafted a “Finance Project Additionality Checklist” that ensures due diligence is performed to assess whether its activities are substituting for what might be available from the private sector. This checklist is aimed at ensuring that OPIC’s operations are not competing with private financial institutions and that its financial involvement in the venture adds sufficient value to justify its participation.

Expanding OPIC’s Use of Coinsurance, Cofinance, and Reinsurance

Are particular dangers hidden in this effort to increase cooperation between OPIC and the private sector? Are there special opportunities? What are the pros and cons of expanding the use of coinsurance, cofinance, and reinsurance with private participants?

Coinsurance

Coinsurance essentially divides up a client’s total insurance needs among two or more carriers. Each carrier performs its own underwriting ac-
cording to its customary specifications and then issues its own contract, which carries its own wording, terms, conditions, tenor, rates, and billings. Coinsurance is usually employed in the private market when a project needs coverage greater than a given insurer normally makes available to any one project, or when a project presents a risk profile that the insurer would prefer to share with other carriers. Coinsurance is also useful to manage the limits a given insurer has with regard to overall exposure in a particular country or sector.

OPIC has engaged in coinsurance from time to time in the past but not to any significant degree and not in any systematic manner. Coinsurance can serve the same purposes for OPIC as it does for private carriers. To the extent that coinsurance draws private insurers into contracts with exposures that they would not be comfortable with on their own, coinsurance can also contribute to OPIC’s additionality.

Because coinsurance requires each insuring party to issue its own contract, the practice can lead to duplication of effort. Moreover, with differences in wording and coverage among the several contracts, different carriers may come to divergent conclusions about whether an individual event is or is not a covered claim. It is unlikely that coverage between OPIC and private insurers will ever be exactly identical in all circumstances. Private participants may have exclusions—such as nuclear war or five powers war coverage—that OPIC is prepared to provide. At the same time, private insurers sometimes offer types of coverage, or expansions of basic coverage, that OPIC does not or cannot offer because of statutory limitations. There also are differences in waiting periods.

The process of putting together coinsurance packages can be smoothed in several ways. Protocols can be negotiated that permit the sharing of documentation with the permission of the applicant. The Claims Cooperation Agreement can coordinate settlement and recovery efforts. There may be benefits to having OPIC take the lead on settlement and recovery on behalf of private insurers. But OPIC does not have to take the lead in salvage, and there may be cases in which there are advantages to having private insurers playing that role.

For OPIC to lead the effort at settlement and recovery on behalf of private insurers does not necessarily require renegotiation of OPIC’s bilateral investment agreements with the countries where it operates. But some of the investment agreements have language that make renegotiation advisable. For example, in Indonesia—as discussed below—the host authorities raised strong objections about entering into salvage negotiations with OPIC that would include compensation for private insurance companies.

Coinsurance arrangements would also have to be managed in a way that did not increase OPIC’s exposure to adverse selection, as is explored in more detail below. OPIC applies the same degree of due diligence in appraising the risk associated with a given project regardless of whether
it is the sole carrier or is participating with other insurers. A risk that is found acceptable to OPIC for the entire term and for all areas of coverage requested is not increased by the fact that private coinsurers might offer coverage for a shorter period, with the option of renewing the policy over the life of the project, or by the fact that private insurers might carve out a certain area of coverage. OPIC would want to ensure, however, that it was not obligated to pick up coverage dropped by private coinsurers, or else it would be left over time with a growing portfolio of particularly troublesome projects.

With regard to coinsurance with other official and multilateral agencies, OPIC has participated in a handful of joint projects with the Multilateral Investment Guarantee Agency of the World Bank Group (MIGA) and with the Export Development Corporation of Canada. In an investment to provide cellular phone service in Brazil, for example, OPIC provided coinsurance with MIGA and AIG. Specific requirements on the part of certain institutions can complicate the formation of joint coverage; MIGA, for example, is required to pursue its own independent recovery.

In examining OPIC’s alternatives for coinsurance, one possible model might be a program similar to MIGA’s Cooperative Underwriting Program (CUP). The CUP arrangement is basically a formal process of syndication in which MIGA takes the lead in putting together a group of coinsurers. OPIC could perform essentially the same function on an as-needed basis. But in investigating the CUP possibility, OPIC has encountered complaints from clients and private insurers about the fees charged by MIGA as a reward for putting together the joint coverage—which more experienced investors judge they could do on their own—as well as about the high ceding commission.

Cofinance

Turning to cofinance, OPIC already co-lends with a number of kinds of financial institutions, including the International Finance Corporation of the World Bank Group (IFC) and the US Export-Import Bank (Ex-Im). Because the composition of the lender group for any given transaction is determined by the borrower, however, the number of times that OPIC’s Finance Department can participate jointly with other lending agencies depends upon what borrowers want.

Multiplying the number of lenders once again inevitably complicates the transaction. OPIC has to ensure that borrowers meet its worker standards and environmental and US-effects requirements. Other than the added complexity, OPIC colending with IFC or Ex-Im represents no unique problems, and it is no more or less difficult than colending with any commercial bank. There is no real “lead” in a financing deal. For some larger projects, an agent for the commercial bank group may be appointed, but this agent has no special rights. OPIC provides financing pari passu
with all senior lenders in the transaction and thus has equal payment and collateral priority with all these lenders. The workout strategy is dictated according to the intercreditor arrangement agreed to by all lenders at the beginning of the project.

OPIC has a formal agreement to cooperate with Ex-Im for projects to which Ex-Im has provided loans and OPIC has provided political risk insurance. Ex-Im and OPIC have also agreed to share counsel unless there is a conflict of interest. Currently, Ex-Im and OPIC have different procedures to ensure sound environmental practices, although the material standards that investors are expected to meet are quite similar. If these procedures could be harmonized, investors and exporters could use a common application when applying to both agencies. However, since OPIC’s standards are more extensive and in some respects more stringent than Ex-Im’s, harmonization would likely have the effect of diluting OPIC’s standards.

Reinsurance

Reinsurance offers another route for OPIC to complement its activities with the private sector, opening up both opportunities and dangers. Reinsurance comes in two mirror-image forms: ceded reinsurance, in which OPIC could lay off business to a reinsurer that assumes the ceded risk; and assumed reinsurance, in which OPIC could take on business from a primary insurer by assuming the risk associated with that business. Both kinds of reinsurance can be employed on a treaty basis (all risks or amounts within a defined category, e.g., a sector, country, level of coverage, or even level of loss) or on a facultative (project-by-project) basis.

Ceded reinsurance would add private-sector participation to projects, permitting OPIC to cap or limit its retention of exposure at any amount it chose. Ceding would allow OPIC to manage concentrations in its portfolio, giving it flexibility to undertake projects in a country or sector where there were pressing developmental or foreign policy needs but where the buildup of past exposure made any new commitments imprudent. There might be strong reasons to support investment in new power projects in Turkey, for example, but the accumulation of past coverage in the power sector in this country could mean that no new OPIC capacity was available. OPIC’s ability to shift part of its past exposures to private reinsurers for which additional coverage in the Turkish energy market might fit well into their portfolios would give OPIC the capability to support new projects that otherwise could not prudently be written.

Ceded reinsurance is more efficient for all parties than coinsurance because it does not involve negotiating multiple contracts with each client, involving multiple wordings and multiple coverages. From the point of view of the purchaser of insurance, OPIC would issue its normal coverage; all transactions with the reinsurer would be invisible. All the customer
would see is an OPIC contract, with the assurance that the full faith and
credit of the US government is present to back up any claim.

During the early years of its existence, OPIC utilized ceded treaty re-
insurance to mitigate the loss potential of inconvertibility and expropria-
tion. OPIC stopped the practice, however, at the direction of the Office
of Management and Budget (OMB). OMB’s reasoning was that, because
the US government has a lower cost of capital, more extensive resources,
and greater capability to spread risk across all taxpayers than any other
entity, it could provide its own reinsurance better than any private com-
pany and should not pay fees for something it could do best itself.

But this line of argument ignores the fact that reinsurance is simply a
management tool like others that the US government purchases exter-
nally. It is not at all unreasonable to expect that OPIC might face real
situations, such as the hypothetical case of Turkey given above, in which
OPIC concluded that its portfolio had a concentration of exposure suffi-
ciently large that it would not be wise to add new projects and still
maintain its ability to be self-sufficient. How should the US government
behave if at some historical juncture US interests would be powerfully
advanced by supporting new projects in Turkey? Should US leaders con-
clude that OPIC’s ultimate recourse not only to its accumulated reserves
but also to the US Treasury provides sufficient self-reinsurance to allow
OPIC to behave with what would otherwise be considered financial reck-
lessness? Or should US leaders forgo support for important new projects
in Turkey in the interest of ensuring OPIC’s financial integrity?

An ability to engage in ceded reinsurance could help resolve this di-
lemma, enabling OPIC to provide the needed support to the new Turkish
projects without behaving imprudently or exposing the US taxpayer to
the risk of having to pay claims. Ceded reinsurance would give OPIC
the flexibility to pass on some of the concentrated coverage to other
parties that wanted to balance their own portfolios with added Turkish
exposure, and thus free up capacity for OPIC to support new projects in
that country.

Success in the use of ceded reinsurance depends, of course, on the
willingness of the private market to accept added exposure at a price
that would appeal to OPIC. In the market of 2002, for example, ceded
reinsurance would probably not have been available or affordable for
the two areas that would have most benefited OPIC’s insurance port-
folio—laying off some business in Argentina and Brazil because of vol-
ume or concentration in those countries, for example, and laying off some
exposure to political violence because of the increased risk associated
with that peril since September 11.

To maximize the probability of finding takers in the reinsurance mar-
ket, OPIC would want the largest number of potential partners. This
raises questions about which private insurers or reinsurers would be al-
lowed to participate: Should the partners for ceded reinsurance be limited
to companies domiciled and incorporated in the United States, because there are only three (AIG, Zurich, and Chubb), be extended to foreign incorporated insurers with US branch offices (Sovereign), or be opened more broadly to others such as Lloyd’s syndicates? Should OPIC also look to reinsurance pooling and/or swap arrangements with other bilateral and multilateral agencies? The answer depends upon whether the objective is to maximize competitive pressures in bidding on OPIC’s portfolio and to minimize constraints on coverage in difficult markets, or to provide favorable treatment to companies domiciled and incorporated in the United States.

It is important to make a distinction between allowing OPIC the option of ceding reinsurance on particular parts of its portfolio that it selects, going forward, and requiring it to cede reinsurance on its existing portfolio of past projects. Private insurers might well find a requirement that OPIC cede reinsurance on its existing portfolio quite appealing, whether they were primary or reinsurance-only carriers, because OPIC’s outstanding portfolio includes diverse projects with varying degrees of risk that are all backed by the full clout of the US government. An obligation imposed upon OPIC to cover its entire portfolio with ceded reinsurance would therefore give over a portion of the premium OPIC receives to private reinsurers while these private reinsurers assumed virtually no new risk.

Still less appealing from OPIC’s point of view would be a requirement to offer to the private sector the opportunity to select whatever portions of OPIC’s existing portfolio they wanted to reinsure, allowing private reinsurers to cherry-pick among existing contracts. The outcome would be to weaken OPIC’s ability to maintain its financial viability without necessarily enabling it to free up capacity where needed the most. Giving OPIC the option but not the obligation to cede reinsurance, in contrast, would allow it to balance the loss of premium revenue against the strategic opportunities that might arise for increasing capacity within particular countries and sectors.

Assumed reinsurance is the converse of ceded reinsurance: it would allow the private market to lay off some of its exposure onto OPIC. This mechanism would facilitate and empower the private market in a number of ways. Private insurers would perform their own underwriting, develop their own rates, and make their own determinations regarding claims. With OPIC as reinsurer, private carriers could offer coverage in circumstances they normally would avoid because they would expect the US government to step in as advocate on their behalf when a claim that touched OPIC was triggered.

Having OPIC as reinsurer would also allow private carriers to maintain the appearance of being the sole source of coverage because the contract would be in the private insurer’s name, with OPIC’s name appearing only on internal documents shared between OPIC and the private insurer.
Therefore, clients, brokers, and financial institutions would see the private market as being viable in far more situations than would otherwise be the case. Once again, however—as in the case of coinsurance—host authorities might not react well to seeing OPIC suddenly step out of the shadows to represent the interest of private insurance carriers.

Because OPIC would want to fulfill its standard underwriting requirements, assumed reinsurance would be possible for it only if the primary insurer required and verified that each project met requirements for US effects, worker standards, environmental protection, and anticorruption (for facultative assumed reinsurance) and that all projects did so (for treaty assumed reinsurance). OPIC would have to price assumed reinsurance coverage to reflect its added risk, and it would have to retain the right to refuse to reinsure in markets and sectors where it was already overly concentrated or prohibited from doing business. It could maximize its developmental and foreign policy impact through facultative reinsurance that allowed it to accept, reject, or insure less than requested, and to provide a quota share or excess of loss coverage as desired by both parties.

Overall, therefore, there is some justification for OPIC to expand its use of coinsurance, cofinance, and (in particular) reinsurance on a selective basis. Yet inherent in these efforts to enlarge OPIC’s cooperation with the private sector, there lurk problems associated with adverse selection, lack of portfolio diversification, and possible anticompetitive effects.

**Potentially Dangerous Consequences of Trying to Maximize Cooperation with the Private Sector**

OPIC’s willingness to support pioneering US firms to invest in novel sectors in novel countries has historically skewed its portfolio toward high-risk areas. But in the past, it has been able to balance its most uncertain activities in the most uncertain areas, to a certain extent, with less risky activities in less risky regions. Concern has nonetheless arisen from time to time that its accumulated reserves might not be large enough to meet all its contingent liabilities, leading to a requirement that the US taxpayer make up the difference.

The papers titled “Is OPIC Adequately Reserved to Support Its Commitments?” and “Loss Reserves: Peer Comparison” (reproduced as appendix A) provide the first publicly available summary of OPIC’s methodology for assessing the appropriate level of reserves to cover the potential risk of loss associated with political risk insurance, investment guaranties, and direct loans. As these papers show, this task has become more complicated in recent years—especially since the dissolution of the Soviet Union—as OPIC has begun to move into geographical regions that have no claim history. Beginning in 1998, OPIC augmented the hist-
torical-record claims basis for building up reserves with stress testing of the portfolio. This involves performing simulations to evaluate OPIC’s ability to absorb large unanticipated claims, taking into consideration concentrations by sector, country, and type of coverage. To absorb the largest plausible shocks, OPIC needs to ensure that it has adequate liquidity (to pay claims while waiting to pursue salvage) and adequate reserves (to absorb losses when salvage is not successful).

What constitutes adequate liquidity and adequate reserves? One benchmark might be to compare OPIC with IFC and MIGA. But simple comparisons are difficult because IFC and MIGA are two separate institutions, with differences in clientele and operating procedures. IFC, established in 1956, provides financing for private-sector projects in the developing world; it can also take equity positions. MIGA, founded in 1988, provides political risk insurance, actively reinsures its portfolio, and participates in a Cooperative Underwriting Program, thus retaining a smaller portion of the risk from its insurance portfolio than does OPIC.

IFC has a significantly greater exposure in project finance than the finance operations of OPIC (IFC’s fiscal 2000 loans outstanding were 2.5 times OPIC’s exposure). IFC’s loss reserves as a percentage of exposure in fiscal 2000 were 18 percent; OPIC’s loss reserves for the same period were 15 percent. With regard to the geographical concentration of the portfolio, Latin America stands out for both IFC (39 percent) and OPIC (31 percent). In Eastern Europe and the former newly independent states, OPIC has 29 percent, compared with 14 percent for IFC. In Asia, IFC has 30 percent and OPIC 14 percent. In the Middle East, IFC’s exposure is 7 percent and OPIC’s 2.5 percent. In Africa, OPIC’s presence derives primarily from its equity funds, not from loans.

MIGA has a much smaller portfolio of insurance coverage ($2.8 billion) than OPIC ($10 billion). MIGA’s portfolio distribution in Latin America is 47 percent, compared with 56 percent for OPIC. MIGA’s exposure in Asia is 4 percent, compared with 18 percent for OPIC. Balancing this out, MIGA has a larger exposure in Eastern Europe and Central Asia, where OPIC’s exposure is small. OPIC’s level of liquid assets available to absorb claims is much larger than MIGA’s, representing 39 percent of the insurance portfolio, compared with 17 percent for MIGA. MIGA, in contrast, has a much higher level of loss reserves (13.4 percent of its insurance portfolio), compared with 3.2 percent of the maximum covered liabilities for OPIC.

The appendix A paper, “Loss Reserves: Peer Comparison,” consolidates the finance, insurance, and equity funds of IFC and MIGA on a pro forma basis to compare with OPIC’s total portfolio of operations.8

8. As an aside, the “Peer Comparison” would seem to indicate that OPIC compares favorably to IFC and MIGA on a cost-efficiency basis. OPIC has administrative expenses of $44 million supporting exposure of $13.3 billion—insurance and finance—compared
OPIC’s level of equity and reserves as a percentage of loans, investment, and insurance exposure is much smaller than the IFC-MIGA combination: 31 percent compared with 75 percent. Although some of this difference doubtless reflects IFC’s need to maintain its AAA credit rating—because IFC must borrow from commercial markets without the backing of the full faith and credit of the US government that OPIC enjoys—this suggests some caution as OPIC copes with adverse selection and lack of portfolio diversification arising from its innovative efforts to cooperate with the private sector.

To remain viable, any insurer or financial institution has to avoid adverse selection and to diversify its portfolio of risks. A health insurer that signs up only chronically ill participants, or a lender that provides funds only to beachfront properties along well-known hurricane routes, is not likely to survive over long periods of time. Each policy or each loan can be priced to reflect a high probability of loss, but the possibility of systemic failure hangs over any institution that is exposed to adverse selection and to an overly concentrated portfolio of risks.

Adverse selection is likely to result, in the first instance, from OPIC’s new practice of offering participation in all prospective projects to private insurers, and watching the latter appropriate for themselves all of the more favorable ones. Adverse selection would be aggravated if OPIC began to coinsure more extensively with the private sector and then promised to pick up—or, worse, were obliged to pick up—areas of coverage dropped by the private sector during the life of OPIC’s own 20-year noncancelable policies. Most damaging would be for OPIC to be required to open its existing portfolio to the private market for the latter to reinsure on a selective basis, again leaving OPIC with only the most undesirable exposures. OPIC will therefore have to be careful—indeed vigilant—that its determination to avoid competing with the private sector does not undermine its ability to be self-sustaining.

In considering the appropriate role for OPIC in relation to private insurance companies, the phrase “insurer of last resort” is frequently used. But there may be a misleading analogy to the role of the Federal Reserve as “lender of last resort.” The Fed has the mission of providing liquidity in the midst of a financial crisis to ensure that credit markets do not “seize up,” in the words of chairman Alan Greenspan, and to head off panic. The Fed is never expected to provide funding directly for projects that the private banking system finds too risky or undesirable. OPIC, in

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with a combined IFC-MIGA administrative expense level of $293 million supporting a similar combined exposure of $13.8 billion. But it is necessary to point out that IFC and MIGA have staff that perform functions that OPIC does not do, such as providing foreign investment advisory services and helping to design and train personnel for investment promotion agencies. In addition, OPIC has had a much longer life span over which to accumulate insurance and finance exposure than have IFC and MIGA.
contrast, could be placed in the position of providing “insurance of last
resort” on a continuous basis—not to avert a panic on the part of private
insurers but to provide coverage for transactions that private insurance
companies find imprudent to take on alone.

OPIC’s additionality initiative could also have anticompetitive implica-
tions for the private insurance market. The movement toward coinsuring
all or most of the most commercially attractive projects with private-
sector insurers sets up the possibility, at least in theory, of allowing the
latter to “game the system.”

As was indicated above, OPIC’s insurance rates are sometimes higher
and sometimes lower than those offered by private insurers. In those
instances when OPIC offers to participate in a coinsurance arrangement
with a relatively low rate for its portion of the insurance, private insurers
could calculate the equilibrium rate at which clients could be expected
to purchase the package of OPIC-plus-private services; private insurers
could then propose a high rate for their portion of the insurance that
would enable the whole package to clear at the equilibrium rate.

Naturally, such calculations will not be perfect. But over time, the partici-
pants could gain the experience needed to produce significant anticom-
petitive effects. If the private political risk insurance industry consisted
of a large number of rival firms, the likelihood of anticompetitive effects
would be very low. But with relatively small numbers of participants,
the probability would rise.