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New Directions and Activities for OPIC

This chapter opens with an examination of the important products that OPIC has recently introduced, in particular its liquidity guarantee facility. It discusses whether the Argentine crisis of 2001–02 requires a fresh look at the issue of "expropriation of funds." It then turns to OPIC products that cope with terrorism and political violence.

The second section of this chapter investigates whether there are lessons to be learned from recent investment disputes in India and Indonesia that might strengthen OPIC operations in the future. The third section enlarges on the discussion earlier in this book of how to expand OPIC's client base for its products in the United States, focusing here on the desirability of revising OPIC's eligibility requirements to include foreign firms with a "significant presence" in the US market.

The fourth section of the chapter examines OPIC's proposal for a new structure for its investment funds program, which uses independent managers to raise equity capital for new small businesses in particular countries or regions.

New Products

OPIC's clients have expressed concern about how better to protect themselves against problems in currency markets, against the threat of terrorism, and against other kinds of political risk.

Protection Against Problems in Currency Markets

Perhaps OPIC's most innovative offering in recent years is its liquidity guarantee facility, which is designed to help investors and lenders protect themselves against currency risk. To put this "liquidity product" in context, it is important to analyze exactly what OPIC is willing to cover and what it cannot cover.

When making or guaranteeing a loan, OPIC accepts all risks once a transaction is completed. These risks include the effects on the project company of inconvertibility, restrictions on the transfer of funds, and the loss of value or devaluation of the local currency.

When issuing political risk insurance, OPIC has traditionally offered inconvertibility coverage that protects against the inability to convert both an investment and earnings on it (including interest on loan investments) from the local currency into US dollars, and to transfer those dollars back to the United States. OPIC's inconvertibility insurance covers the imposition of exchange controls as well as shortages in foreign exchange that may result from economic events in a country.

OPIC's inconvertibility insurance does *not* cover devaluation, only the inability to convert and transfer. For example, if an investor is able to convert earnings into US dollars but at a less favorable exchange rate than when the investment was made, the resulting loss would not be covered by OPIC's inconvertibility insurance.

OPIC's new liquidity product was developed when Bank of America Securities approached OPIC with a request to assist in a bond financing for Tiete, a company that owns hydroelectric projects in Brazil. The sponsor was the AES Corporation.

Bank of America and AES originally proposed a method of dealing with devaluation risk when the project revenues from the operating company's sales contracts would be fully indexed to local inflation, rather than indexing to the US dollar (indexing to the US dollar is not permitted under Brazilian law). The Bank of America–AES approach was based on the concept that the long-run equilibrium value of a currency in international markets is determined by the level of inflation in that country relative to US inflation. The assumption was that the depreciation in the value of the local currency against the US dollar should over time be equal to the difference in inflation rates between the United States and another country.

To evaluate this approach, OPIC retained Wharton Econometrics (known as WEFA) to conduct an analysis of various countries, including Brazil. WEFA examined the Brazilian experience during the preceding 20 years and concluded that there had been a strong correlation between local inflation and depreciation of the currency over the long term. The empirical evidence suggested that the nominal local currency–US dollar exchange rate had closely followed the expected exchange rate, even during the period of hyperinflation in the early 1990s.

However, because the inflation adjustment mechanism in the sales contracts of operating companies is reset on an annual basis, there is exposure to intraperiod currency changes (i.e., the long-term trend may not hold true in any specific year between adjustments or between the dates required for payments on the bonds). The data contained in the WEFA study suggested that the amounts of potential exposure during such periods could be adequately mitigated through either sufficient project debt-service coverage capacity or reserve accounts, or through a combination of both.

OPIC's liquidity product is designed to mitigate intraperiod risk. The operating company's sale contracts are pegged to the local inflation index on an annual basis, whereas conversion of project cash flows from local currency to US dollars at then-prevailing foreign exchange rates takes place more frequently and debt-service payments are made semiannually. As a result, during periods of depreciation, offsetting revenue increases will lag behind the expected changes in foreign exchange rates, thereby increasing the likelihood and size of a guaranty payment. This effect will exist on an intraperiod basis whenever depreciation occurs, regardless of whether such depreciation is offset by changes in local inflation. The magnitude of the effect will increase as local inflation rates increase and depreciation occurs within the period that the tariff payments remain fixed.

The terms of OPIC's guaranty in this case ensure, in certain predetermined and limited circumstances, that the operating company will have a fixed level of US dollars available for debt service, notwithstanding exchange rate variations. The guaranty provides support for variations in currency exchange rates relative to Brazilian inflation, rather than operating results. To accomplish this, the sponsor and OPIC must agree on a base financial forecast. Payments under the guaranty will be made to service bond debt only if the forecast is not achieved because devaluation is more rapid than the inflation adjustments in the sales contracts, and the project cannot otherwise meet the payment due.

If OPIC makes a payment under its guaranty and the operating company subsequently has excess funds, such funds will be held in a segregated trust account for the benefit of OPIC only. Such funds will be used before any future payments by OPIC. Moody's Investor Service (2001) has commented that this liquidity facility is structured essentially as a "revolver:" OPIC's coverage is capped at $30 million, and for every devaluation claim OPIC pays, a subordinated loan will be created to the sponsor in the same amount.[1] Repayment will take place semiannually from all excess cash available that would otherwise have been distributed. The repayment thus serves to replenish the devaluation coverage.

Moody's Investor Service (2001) examined projections showing that less than $5 million of the policy would have been necessary had the bonds been sold in 1982, at the commencement of the worst extended

[1] See also Fitch IBCA, Duff & Phelps (2001); and "AES Tiete: Latin American Refinancing Deal of the Year 2001," *Project Finance Magazine*, March 1, 2002, 30–33.

real–US dollar period in the previous 30 years. Moody's also calculated that the $30 million ceiling on OPIC coverage would cover on average a 90 percent devaluation in any single year, the probability of which was considered to be very low.

Through the use of this liquidity product, OPIC was able to facilitate bond financing in the amount of $300 million, while limiting its exposure to $30 million. The coverage for the Tiete investment was structured specifically for a power project that had strong commercial underpinnings, robust expected cash flows, ample debt-service coverage ratios, and a reliable off-taker. Thus, the use of this product to provide coverage for other projects would have to be evaluated in light of the particular characteristics of each individual case.

Issues Resulting from the Argentine Crisis

The crisis of 2001–02 in Argentina has raised novel issues with regard to the nature of convertibility and repatriation insurance, and with regard to the relationship between currency coverage and expropriation coverage.

The difficulties for investors originated when Argentina imposed currency transfer restrictions for a limited amount of time, a period shorter than the waiting periods for claims in most political risk investment insurance contracts. By the time foreign investors became able once again to exchange pesos for dollars, and to transfer these dollars out of the country, the exchange rate had collapsed, leaving them with huge losses but without a claim under their convertibility and repatriation coverage.

The point of contention that emerged centered on whether investors with political risk insurance could claim that this sequence of actions constituted an expropriation of their funds, and whether the restrictions on convertibility and repatriation constituted a political event (triggering political risk insurance) rather than a commercial event associated with devaluation (not covered under political risk insurance).

It would appear that for OPIC expropriation coverage to be triggered, the actions of the Argentine government would have to be a violation of international law (so as to constitute a "taking" of the funds), would have to result in a default on a scheduled payment (if the coverage is for institutional lenders), and would have to extend throughout the prescribed waiting period (which is a minimum of 60 days in most OPIC contracts).

The Argentine experience leads to fundamental questions about whether the language in convertibility, transfer, and expropriation policies might have to be changed. Should the definition of expropriation be reformulated, for example, to let all parties know whether "expropriation of funds" via the blocking of convertibility and repatriation while a country is struggling with a potential devaluation is, or is not, covered? Are the waiting periods on inconvertibility insurance so long that the policies effectively lock the purchaser into exposure to a potentially huge devaluation?

Terrorism Coverage

After the events of September 11, 2001, does OPIC need a new product to respond to the threat of terrorism? OPIC has always included terrorism coverage in its basic political violence insurance, which defines political violence as "a violent act undertaken with the primary intent of achieving a political objective, such as declared or undeclared war, hostile action by national or international armed forces, civil war, revolution, insurrection, civil strife, terrorism, or sabotage." Actions undertaken primarily to achieve labor or student objectives are not covered. OPIC's political violence coverage protects an investor's physical assets with compensation based either upon the value of the assets or upon lost business income, or both, as elected by the investor.

In general, therefore, it would not appear that OPIC needs a new insurance product for individual projects in order to respond to the threat of terrorism. In the aftermath of September 11, it has become clear, however, that some investors would be interested in purchasing portfolio coverage for all their overseas operations as opposed to per-project coverage; that is, if an investor had facilities in 50 countries, the investor would like to purchase terrorism coverage for operations in all 50 countries.

The portfolio approach would make terrorism coverage more affordable, because the insurer would be accepting a basket of diverse risks and could price them accordingly, and more time effective, because the insurer would not be evaluating multiple investments in multiple countries in depth. For OPIC to provide such portfolio coverage would be difficult, if not impossible, however, in light of its multiple statutory requirements for each and every project, plus capacity restrictions by country and sector.

To address the risks of terrorism and sabotage in projects in which OPIC is a lender, OPIC's Finance Department requires its larger borrowers to obtain insurance for these events when insurance is available on a commercially reasonable basis. Failure to maintain such insurance constitutes a default under the OPIC loan agreement. In the event that such insurance might become commercially unavailable, there is no way for the borrower to cure the default. Under this scenario, the Finance Department would find repayment of its outstanding loans exposed to the risks of terrorism and sabotage.

OPIC's statutes do not permit it to provide US domestic coverage. Thus it would appear that OPIC would not be involved in programs to provide public-sector terrorism coverage for actions within the United States.

Other New Products

Among other new products, OPIC might begin to provide insurance to cover defaults on government contracts. This coverage would protect bondholders against the repudiation by a host government of its sovereign guaranty to support a company bond offering. The goal would be to provide an assurance of debt-service payments to bondholders if the company were to default on its bond payments, the host government were to repudiate its backing for the interest payments, or the host government were to fail to comply with a subsequent arbitral award requiring payment on the sovereign contract of guaranty. The objective for issuing this type of coverage would be to raise the credit rating of emerging-market company bonds from subinvestment grade to investment grade.

A second potential new product would cover the enforcement of intellectual property rights. It would protect investors against infringement due to the failure of foreign governments to respect treaties governing intellectual property rights. The development of this product will require complex assessments about how to value the type of right protected, how to price the product, and how to specify the circumstances under which to trigger payment of a claim.

Lessons Learned from Recent Investment Disputes

Do the experiences of the recent past in India and Indonesia, as discussed below, provide lessons about how traditional products might be redesigned or restructured? Cases from these countries raise questions about long-term official protection of deal structure, about contagion and the distinction between political and commercial risk, and about moral hazard.

Long-Term Official Protection of Deal Structure

Chapter 1 of this volume highlighted the unique role that OPIC can play in deterring adverse host-country action under circumstances in which host authorities find themselves unable to make credible commitments to honor long-term contracts. This “market failure” in writing contracts justifies public-sector intervention even when the services of private political risk insurance companies in providing compensation to investors are available. But recent disputes involving Dabhol in India and MidAmerican in Indonesia require examination of whether this role needs to be tempered and circumscribed.

As was presented above, the rationale for OPIC participation in providing political risk insurance and financial guarantees drew upon the “obsolescing-bargain” model of the evolution of relations between foreign investors and host authorities. In this model, changes in the project’s level of commercial risk combined with changes in the evaluation of investors’ unique benefits 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 authorities agree to these terms to attract the investment. But once the project is successful, they (or their successors) do not want to continue 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—or for recipient-country misbehavior—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. "Pioneer projects" and "first movers" are particularly prone to the dynamics of the obsolescing bargain, but later investors are subject to the phenomenon as well.

Throughout the interaction between investors and host authorities, in the obsolescing-bargain model, there are legitimate questions about how long investors in admittedly risky projects should receive a return that reflects the opening risk premium once the project is successful. Similarly, there are legitimate divergences between investors who want "winners to pay for losers elsewhere" and host authorities who do not want to be stuck with terms designed to compensate the investors for mismanagement or mistreatment in other projects and other countries. Finally, there are legitimate public policy concerns that the investment agreements of early participants might contain sole-supplier terms, or extremely large output purchase requirements, which should disappear as alternative suppliers or cheaper sources of supply become available.

The Dabhol case illustrates some of these dilemmas. It is important to note that the Dabhol disputes originated during the construction and early operational phases of the power project, not during subsequent long-term swings in the investor-host relationship. But the Dabhol case raises the question of whether projects structured like this may not simply be time bombs waiting to explode.

According to publicly available documents, the initial agreement between the Enron–Bechtel–General Electric investor group and the state government of Maharashtra, backed by the Government of India, was signed without competitive bidding on the project, as were the construction and equipment purchase contracts.[2] The Enron-led investor group

[2] See the Harvard Business School's case study titled "Enron Development Corporation: The Dabhol Power Project in Maharashtra, India (A, B, C)," 1997. As indicated in this IIE book, chapter 2, OPIC turned the Dabhol case over to the US Department of Justice for possible criminal investigation of violations of the Foreign Corrupt Practices Act.

asked that the price of electricity be set to yield an annual rate of return in excess of 30 percent; after objections from the Government of Maharashtra, the energy payment structure was refashioned to produce an annual rate of return of 25.22 percent.

The Maharashtra State Electricity Board (MSEB) provided a guarantee to purchase 90 percent of the power from the Dabhol project for 20 years. MSEB payments were to be made monthly in rupees, but MSEB assumed the entire risk of any changes in the rupee-dollar exchange rate over time. The Maharashtra state and Indian national governments guaranteed the dollar-equivalent obligations under the power purchase agreement in case of default by MSEB.

Were host authorities at the state and national levels locking the local utility into an excessively large purchase agreement (the World Bank calculated that the Dabhol plant would create a substantial amount of excess base-load capacity at relatively high prices)? Did the state and national governments assume too much exchange rate risk (the nearest equivalent is the case of the Spanish government guaranteeing the external loans of private contractors building toll roads, costing the Spanish taxpayer $2.7 billion when the peseta depreciated relative to the currencies in which the contractors borrowed)? More broadly, were terms that might well be defended in the first 5 or 10 years of the project justified for 15 or 20 years? Did OPIC adequately investigate allegations that the investors were complicit in human rights violations of protestors on the part of the Maharashtra state government?[3]

This case poses fundamental questions about the framework within which OPIC has traditionally operated. Independent of any possible evidence of corruption in a given project, should OPIC now begin to examine the terms and conditions of foreign investment agreements to determine whether they are excessive or imprudent along some dimension, as part of its own due diligence in assessing the likelihood that those terms and conditions will be altered or canceled by host authorities? Should OPIC rethink its standard offer of 20-year coverage?

With regard to large power projects and other infrastructure investments, should OPIC begin to subject the applications to sensitivity tests to determine the degree to which demand projections could fail to meet expectations and the projects still remain viable, and insure only those that exceed some standard? For example, might OPIC begin to refrain from providing insurance coverage to an energy infrastructure project

[3] Human Rights Watch (1999) alleges that the Maharashtra Police and State Reserve Police Forces committed human rights violations in at least 30 demonstrations against the Dabhol project in 1997 and at other demonstrations in other years. The project sponsors reimbursed the state government for the cost of police officers stationed near the site, and, according to Human Rights Watch, used an Enron helicopter to transport police inspectors and conduct surveillance of protestors.

whose power purchase contract constituted more than some maximum threshold of a utility's base-load requirements, such as 70 percent?

Financial Contagion, Political Versus Commercial Risk, and Moral Hazard

The MidAmerican case in Indonesia points to additional thorny issues and dilemmas in separating political from commercial risk, dealing with financial contagion, and avoiding moral hazard. According to publicly available documents, MidAmerican signed agreements to build geothermal power projects on the basis of take-or-pay power purchase agreements with the state-owned utility Perusahaan Listrik Negara (PLN); see Martin and Bracey (2001). The Indonesian Ministry of Finance provided a support letter, pledging that it would cause the state-owned oil and gas corporation (Pertamina) and PLN to honor and perform their obligations under the agreements for these geothermal projects.

With the spread of the Asian financial crisis in 1997, the Indonesian government attempted to reduce its budgetary outlays drastically, at the urging of the International Monetary Fund and other multilateral institutions. With the onset of the crisis, the extent to which the IMF and the World Bank—which exercised a significant degree of influence on the Indonesian government—would advocate and implement policies that were antithetical to the viability of foreign private investors took many players by surprise, not least of all OPIC.

As part of this budgetary compression, the Indonesian government issued a decree dividing all infrastructure projects undertaken by or in conjunction with any state-owned entity into three categories: continued, under review, and postponed. Over the course of 1998, MidAmerican's projects were placed under review, and when PLN failed to make all the required payments, MidAmerican pursued its rights under arbitration. In 1999, two consecutive arbitration panels found PLN in breach of contract, at which time MidAmerican filed claims with OPIC and with private political risk insurers, receiving full payment of $290 million under its political risk insurance policies.

In the actual evolution of the MidAmerican case, the Indonesian government took several extraordinary and perhaps inexcusable steps. It attempted to thwart the arbitral process by countersuing MidAmerican, issued an injunction prohibiting MidAmerican from trying to enforce the first arbitral award, enjoined the second arbitration from proceeding under threat of criminal prosecution, and physically removed the Indonesian arbitration member from the second round of arbitration.

But the case raises broader issues of how to deal with countries and projects engulfed by economic and financial contagion. Indonesia found itself committed to power projects and power capacity that it did not need and for which it did not have the financial wherewithal to pay—for reasons external to its own macroeconomic management—within a legal contractual arrangement that placed payment to a foreign corporation ahead of all other funding necessities, including importation of food and other basic necessities for a stricken population. Is it plausible to expect host authorities in such straits—even thoroughly honorable host authorities that do want to play by the rules to the extent possible—to place paying an arbitral judgment ahead of all other considerations?

In preparing for possible instances of economic and financial contagion in the future, how should OPIC both separate out commercial risk from political risk and also distinguish between intention and capability on the part of host-government actors? Traditional definitions of political risk focus on deliberate acts by host-country authorities motivated by an intention to change the treatment of a foreign investor. Changes in external market conditions over which host-country authorities have no control that reduce their capability to perform as expected, in contrast, fall under the rubric of commercial risk. Should a public-sector political risk insurer such as OPIC provide coverage for events that border on commercial risk? Is there a need to redefine what constitutes a trigger event for OPIC's political risk policies in such circumstances as the Asian financial crisis? Should public-sector political risk insurers contemplate a kind of "force majeure" exception to deal with economic and financial contagion? Or would this open the door to almost any government being able to claim that forces beyond its control were driving it to repudiate its contracts?

The MidAmerican case also gives rise to questions about possible moral hazard deriving from political risk coverage. MidAmerican, buffered by its OPIC policy, decided to demand compensation, whereas other investors in the same predicament (but without OPIC coverage) took the route of negotiating a workout with the host authorities. Unocal and Jawa Power entered into restructuring negotiations with the Indonesian government, noting that their long-term preference was to remain involved in the country's power sector. Might the purchase of OPIC insurance cause foreign investors—or their private-sector creditors (if the banks financing a project refuse to authorize a workout)—to behave differently than they might have in the absence of OPIC coverage? Does the decision to demand compensation rather than to engage in a workout derive from possession of political risk insurance in general, or from OPIC coverage more specifically?

Implications of the Enron Collapse

What are the implications of the Enron collapse for insurance coverage or guarantees for project finance, given the reliance placed on sponsor completion guarantees, stake in the project, and managerial role? Are there lessons to be learned about securitization and the use of derivatives? To what extent should lenders rely on public audited financial statements that are filed with the Securities and Exchange Commission, or is there a need for more due diligence in scrutinizing the books of investors that use off-balance-sheet financing?

OPIC in the Age of Globalization: New Clients, Larger Deal Flow, Revised Eligibility Requirements

Chapter 2 of this volume analyzed the need for several modifications in the constraints under which OPIC operates that would expand its universe of potential clients, especially among investors in the manufacturing and services sectors. As reported there, the evidence shows that firms that engage in outward investment use superior technologies, enjoy higher productivity, pay higher wages, and provide more stable jobs than similar firms that do not engage in outward investment. But this process of becoming "globally engaged" is highly dynamic, with job changes and job losses as well as job gains and job improvements.

In this context, the preoccupation in OPIC authorizing legislation with preserving virtually every existing job at the plants of firms undertaking outward investment—as a way of enhancing the strength of the home economy—is misguided. What is needed is a new "US net effects" test that separates out proposed projects according to what would be the impact on the home economy if the proposed foreign investment did take place, in comparison with the outcome if it did not. In the vast majority of cases—but not all—the test would show that firms, workers, and communities would be more competitive, with better jobs and higher levels of compensation, with outward investment than without it.

Changing OPIC's statutory requirements regarding US effects would make its services available to many firms that simply do not bring projects to it under present circumstances. This expansion of its client base would be assisted by a shift in its internal procedures away from its current defensive and restrictive stance, which screens out most projects in the manufacturing sector, toward a more facilitative posture. Such a shift is further justified by evidence showing that US investment in semiskilled manufacturing, assembly, and service industries tends to raise labor standards and improve worker treatment around the world, not only in the plants of the investors themselves but also in lower-skilled plants in the same countries, regions, and industrial zones.

This new proactive approach to marketing OPIC services to firms throughout the US economy would be enhanced by the recommendation that OPIC target its efforts toward serving small and medium-sized firms that find themselves ready to move from exports to initial offshore investments. To accomplish this without building up a large new bureaucratic apparatus, OPIC should introduce investor support services into the already functioning export-assistance infrastructure. The US Foreign Commercial Service provides export-counseling services to US firms through a network of offices in 47 states and has officers in US embassies in 84 foreign countries. The US Export-Import Bank is represented in 6 of these domestic centers in the United States.

In addition, Department of Commerce specialists located domestically and overseas offer "Gold Key" custom-tailored service for US firms planning to visit a country that includes briefings, interpreters, industry reports, and introductions to potential partners. Many states and municipalities have special export support offices. And 19 US Export Assistance Centers are dedicated to providing export-promotion services that combine the services of the Department of Commerce, the Ex-Im Bank, the Small Business Administration, and other export-related federal and state agencies.[4] By providing training to these commercial export-promotion officers and helping to build a "one-stop shop" for exporting and investing, OPIC can mobilize these commercial officers to help search out those US companies that are ready to undertake foreign direct investment (FDI) to complement their penetration of external markets and that might need OPIC support.

But there is also another large market of potential purchasers of its insurance that OPIC today is forced to ignore. For it to be able to serve this large market, its eligibility requirements would need to be changed.

"Who-Is-Us?" and Revised Eligibility Criteria

By now it is a commonplace to observe that globalization has changed the face of the US economy. Between 1997 and 2001, more than 4,500 US companies were acquired by or merged with foreign corporations. Some have no remaining US ownership (e.g., Giant Food, ADT Security Service). Others have become part of a foreign corporation, with US shareholders acquiring stock in the new combined entity (e.g., the Chrysler Corporation was merged into Daimler Benz AG, a Germany public company, and Chrysler stock owners became shareholders of Daimler Benz, which changed its name to DaimlerChrysler).

To cite further examples of this globalization process, since acquiring Westinghouse, Siemens-USA has become larger than Siemens-Germany, employing more than 90,000 workers in the United States. And many foreign companies have set up "greenfield" operations in the United States, building new plants in South Carolina or Alabama, for example, without acquiring US firms in the process. The United States is now the world's largest host country for FDI.

[4] US Export Assistance Centers are located in Atlanta, Baltimore, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Long Beach, Miami, Minneapolis, New Orleans, New York, Philadelphia, Portland, San Jose, Saint Louis, and Seattle.

This globalization has led to a debate about "Who is us?" In most public policy analysis, the answer has shifted over the past decade from defining "us" according to narrow nationality-of-ownership criteria to broader criteria related to the extent to which a firm's operations touch the lives of workers, managers, suppliers, and communities on the ground in the United States, independent of ownership characteristics. An "us" identity—"our" livelihood, "our" economy, "our" country—is intertwined with the activities of a growing number of companies with diverse national origins of ownership.

From 1988 to 1999 (the most recent year for which data are available), the contribution to the US GDP from affiliates of foreign corporations in which there was less than 50 percent US ownership grew by 45 percent, from 3.8 percent of GDP to 5.5 percent, generating $391 billion in local business activity in 1999. These affiliates generated 4.5 percent of total US private-industry employment and 12.3 percent of total US manufacturing employment.

By sector, affiliates of foreign corporations in the United States accounted for 30 percent of all workers in the chemical industry; 27 percent of all workers in the motor vehicle and parts industry; 21 percent of all workers in the electrical equipment and components industry; and 14 percent of all workers in the mining and petroleum industries. A calculation of sales made by US-based suppliers to these affiliates of foreign corporations would add substantially to their contribution to US GDP and to aggregate employment.

These affiliates of foreign corporations provide compensation and value added per worker that is comparable to domestic companies in similar sectors, and above the average for all US firms (Graham and Krugman 1995).[5] Company-funded research and development per worker is slightly higher than for domestic firms in the same sector, and much higher for affiliates of foreign corporations than for all US firms.

Affiliates of foreign companies in which there is less than 50 percent US ownership have consistently accounted for approximately 20 percent of total US exports of goods. In 1999, exports from these companies equaled $130 billion. To enable US workers and communities to capture the benefits associated with this dynamic international activity, the US Export-Import Bank determines eligibility on the basis of whether the goods that are to be exported are manufactured in and shipped from the United States. Foreign-owned firms that meet this criterion are allowed to participate in Ex-Im's programs.

The same is not true of OPIC. OPIC's statute limits issuance of insurance and loan guarantees to eligible investors. The statute defines "eligible investors" as US citizens, US entities "substantially beneficially owned" by US citizens, foreign corporations more than 95 percent owned by US

[5] These findings are confirmed by Glickman and Woodward (1989).

citizens, or other foreign entities 100 percent owned by US citizens. OPIC has traditionally defined “substantially beneficially owned” as requiring majority US ownership.

With regard to OPIC’s insurance, the insured investor, not the project company, must meet the eligibility test.[6] With regard to OPIC’s financial guarantees, the lender, not the sponsor or project company, whose loan is guaranteed by OPIC—that is, a bank or a holder of an OPIC Certificate of Participation—must meet OPIC’s eligibility test.

At the instigation of and with considerable support from the US banking community, OPIC has considered what might happen if its eligibility requirement were changed from majority US-owned firms to 25 percent US-owned firms. The principal benefit of such a change would be to enable OPIC to support US banks seeking political risk insurance for syndicated loans in which they represent 25 percent or more, but less than 50 percent, of the loan amount.

But a hypothetical shift from a 50 percent US-ownership requirement to a 25 percent one is not likely to increase the number of domestically located firms eligible for OPIC insurance to any substantial extent. This is the case because the predominant proportion of the foreign firms investing directly in the United States or acquiring US companies within the United States are wholly owned subsidiaries of external corporations.

Therefore, the most effective way to ensure that US workers, suppliers, and communities can take advantage of the international dynamism of foreign corporations that want to use the US market as the base for outward investment would be to change OPIC’s statute to a “significant presence” test for eligibility, defined in some simple and straightforward way, such as employment of 250 or more, or 500 or more, workers within the US economy. This would bring OPIC into congruence with established US Government Advocacy Guidelines, in which support for foreign-owned, US-incorporated firms is considered to be in the US national interest when the operations to be supported involve US materials, equipment, and labor and may contribute to the US technology base, to the repatriation of profits to the US economy, and/or to follow-on business that would benefit the US economy.

A New Structure for OPIC Funds

OPIC’s program of investment funds was created in 1987 with the objective of finding a way to deploy capital broadly to small, risky projects in regions, such as sub-Saharan Africa, where there were few firms that

[6] OPIC looks separately at investor eligibility and project eligibility; project eligibility is determined by 25 percent of the equity in a project being owned by an eligible investor.

could meet even minimal requirements for a loan. The concept has been to provide a loan from OPIC to a third-party fund manager, who leverages the loan by raising equity capital in private markets and then deploys these resources to a portfolio of projects in a given area.

OPIC does not participate in investment decisions made by the fund. However, the fund manager must bring each proposed fund investment to OPIC for review to determine whether the investment would be consistent with OPIC statutory criteria, including workers' rights, environmental protection, and US effects. OPIC's financial guarantee, backed by the full faith and credit of the United States, may be applied only to the debt portion of the fund's capital. OPIC-guaranteed debt must be held by "eligible investors"; that is, by US citizens, US corporations and partnerships that are more than 50 percent beneficially owned by US citizens, and foreign entities wholly owned by US citizens. OPIC does not offer any guarantee of the fund's equity, and all equity investments in OPIC-supported funds are fully at risk and are subordinate to any OPIC lending or guaranteed debt.

The first OPIC investment fund was the African Growth Fund, which raised $5 million in equity and began to invest in 1991. Since then, OPIC has supported 30 private equity funds—2 of which have been repaid or written off—with a maximum exposure of $3 billion, 42.5 percent of OPIC's total credit exposure.

By region, 21 percent of committed capital (debt and equity) have been in the Newly Independent States (NIS, including Russia), 18 percent in Africa, 16 percent in Eastern Europe, 12 percent in Southeast Asia, 10 percent in South America, 4 percent in the Middle East, and the remainder in other OPIC countries. By sector, 23 percent has been in manufacturing, 22 percent in services, 13 percent in communications, 13 percent in power, 12 percent in financial services, 7 percent in construction, 4 percent in agriculture, 2 percent in transportation, 1 percent in mining, less than 1 percent in information technology or tourism or medical, and 3 percent in other sectors.

In total, OPIC-supported funds have invested about $1.9 billion in 216 firms in more than 40 countries. These firms have created more than 45,000 local jobs and generated $695 million in tax revenues for host authorities.

There is evidence, in addition, that some OPIC investment fund managers have helped recipient firms with new management, marketing, quality control, environmental, and human resource procedures and have acted as a sounding board for local managers' ideas. The India Private Equity Fund, for example, aided the Gujarat Glass Company in shifting from low-margin, low-end production of pharmaceutical containers to higher-end products for the perfume and cosmetics industry. Fund experts showed Gujarat how to capitalize on its ability to make custom bottle moldings on-site by taking individualized orders from high-margin customers (only three other companies in the world make their own molds).

There are also cases in which OPIC investment fund support has generated various kinds of socially valuable spillovers. For instance, the India Private Equity Fund's support for the HDFC Bank, in preparation for filing an American Depository Receipts listing with the New York Stock Exchange, put pressure on older state banks to adopt more stringent auditing and transparency standards. The HDFC Bank also took a leadership role in advocating the enactment of a foreclosure and bankruptcy law, which was passed by the Indian Parliament in January 2002.

Some OPIC-sponsored investment funds appear to have had a substantial multiplier effect. The manager of the Newbridge Andean Partners (NAP) fund, for example, has estimated that OPIC's initial $100 million loan stimulated $137 million in NAP investments, $74.7 million in equity coinvestments, and $330 million in vendor financing, for a total of $542 million flowing from OPIC's original commitment.

In several cases, OPIC support for a given fund has had a demonstration effect, whereby managers with whom OPIC has worked have been able to raise follow-on funds without OPIC's participation. There have been non-OPIC-supported follow-ons to the First NIS Fund, the Poland Partners Fund, the Emerging Europe Fund, the Israel Growth Fund, and the Asia Pacific Growth Fund. In the last case, 17 funds have subsequently grown up in the Asia-Pacific region, with an aggregate of $1.7 billion in capital. In the process, local stock markets have expanded and become more resilient.

Finally, the OPIC investment funds have had a substantial impact on the US economy. OPIC has calculated that the funds have generated $3.2 billion in US exports, supporting 9,500 jobs in the United States. Moreover, the funds provide a vehicle for responding to the foreign policy initiatives of the executive branch and Congress. For instance, the Sub-Saharan African Funds sprang from the Africa Growth and Opportunity Act–Africa Initiative. The NIS Funds followed the 1992 Freedom Support Act. The Southeast Europe Equity Fund arose in 1999 as part of the Stability Pact for the Balkans.

In the late 1990s, the performance of OPIC's investment funds suffered from the volatile performance of emerging-market economies, especially in Asia, Russia, and Latin America. The funds' performance also suffered from the appointment of fund managers with no previous experience managing fund operations. In 2000, the US General Accounting Office reported that 14 of 26 fund managers had not been selected through a competitive process, and that 10 funds were then showing a zero or negative annual average return (US General Accounting Office 2000). Only in 1998 did OPIC adopt the practice of soliciting competing fund manager proposals for each prospective fund and selecting winners on the basis of proven success in investment fund management or in a related industry.[7]

[7] Final decisions on the establishment of new funds are made by OPIC's board of directors. OPIC has also begun requiring that the funds provide a publicly releasable description of each investment made.

Even more problematic, however—in the view of OPIC—has been the imbalance among the amount of debt OPIC lends to each fund, the amount of equity supplied by the fund manager and the limited partners, and the exposure of the various parties to profit or loss from fund projects. For a typical private-venture capital fund, the limited partners supply 98 or 99 percent of the fund's capital and the general partner provides 1 or 2 percent. Any capital gain from the fund is usually divided between the limited partners and the general partner, with 80 percent going to the former. The members of the general partnership will usually own a separate management entity that is paid an annual management fee of approximately 2 percent of the capital committed to the fund. The fund may have a 10-year life, with some option for extension.

In its fund structure, in contrast, OPIC provides two-thirds of a fund's capital in the form of senior debt, and as a senior lender to the fund it receives a debtlike level of return, with a repayment priority over that of equity investors. OPIC would charge a risk premium of 150 basis points above its cost of capital, and it would receive an upper limit of 6 percent of the fund's net profits after the fund has fully repaid its debt. OPIC's capital thus leverages the return to the equity investors, who provide one-third of the capital but receive 94 percent of the profits.

In OPIC's assessment, the result of this arrangement has been a mismatch between the risk OPIC absorbs and the return it can expect to earn, notwithstanding the fact that it is a senior secured lender to the fund and stands at the head of the line for repayment. OPIC has essentially been bearing an equity-like risk but not receiving an equivalent risk-adjusted return. Although funds with moderate success or better might be expected to repay their OPIC debt and provide some limited return to their investors, there is the possibility that the limited profits, fees, and interest OPIC currently receives on successful funds would not adequately cover potential losses on unsuccessful funds.

As a consequence, OPIC has proposed to change its investment fund structure in fundamental ways. Beginning in 2002, OPIC undertook to revise the risk-reward relationship for new funds, so as to limit its exposure to catastrophic losses. In the new approach, OPIC intends to provide a much smaller proportion of total fund capital—on the order of 25 percent—and to command a higher potential return. As part of the new structure, OPIC will continue to provide some funding, treated as it has been in the past, as senior debt with repayment priority.

A second portion of OPIC funding will be treated as "mezzanine debt," that is, as repayable pro rata with the equity. In this arrangement, OPIC aims to receive a performance-based return on the mezzanine debt. This mezzanine debt, perhaps 20 percent of the total OPIC participation, will be subordinate to the senior OPIC debt, receive a higher interest premium, and claim a portion of the return to equity equal to the proportion it represents of all equity plus mezzanine debt. Repayment of this mezzanine debt therefore will be variable both with respect to the timing and the amount of return, built upon a higher base interest rate.

The objective of this proposed structure is to enable OPIC to support a greater number of investment funds with a given amount of capital on a more sustainable basis. Most other multilateral development institutions (e.g., International Finance Corporation, European Bank for Reconstruction and Development, and Commonwealth Development Corporation) currently limit the amount of their investment in any one fund to 25 to 35 percent of total fund capital. This new framework should also reduce the risk to OPIC of a catastrophic loss from any single fund that cannot be compensated for by profits from successful funds. By increasing the ratio of equity to debt in each fund, OPIC will expand the cushion available to cover losses before the senior debt is unable to be serviced.

The question that only the market will be able to answer is whether private investors will be willing to extend their activities in untried and highly risky regions when they have less US government lending to leverage their own capital. If not, the new structure may mean that OPIC's ability to mobilize capital for deployment in less developed and least developed countries will weaken.

Moreover, concern has emerged about whether there might be a double standard for environmentally sensitive Category A projects in the portfolio of OPIC funds in comparison with similar projects directly supported by OPIC insurance or loans. OPIC reports that the majority of its funds were authorized before the issuance of OPIC's *Environmental Handbook* in April 1999 and the statutory requirements for public disclosure of environmental impact assessments for Category A projects, which became effective in fiscal 2000. OPIC's new environmental disclosure requirements were not applied retroactively to preexisting OPIC funds because this would have constituted a breach of contract.

For funds authorized since 1999, OPIC has instituted a 60-day host-country public disclosure requirement for Category A projects, and it has required all funds that invest in Category A projects to assign an environmental coordinator to ensure that OPIC's environmental standards are applied when the project enters the fund's portfolio. OPIC reports that it screens and reviews all fund projects to ensure that its environmental requirements are met. As was indicated in the analysis of OPIC's environmental procedures for those projects receiving direct insurance or loans, however, OPIC's Web site does not now include a transparent way for outside observers to identify and track many of the most environmentally vulnerable OPIC-supported projects.