COSTA RICA:
MANAGING LIQUIDITY RISK THROUGH CONTINGENT LINES OF CREDIT

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Costa Rica & World Bank: A Partnership to Reduce Vulnerabilities

Exogenous Causes of Liquidity Risk:

- Costa Rica's geographic location makes it prone to natural disasters:
  - Hurricanes, floods, earthquakes, volcano eruptions, etc.
  - Vast experience in managing natural disasters

- Also, as a small open economy, Costa Rica is highly vulnerable to volatile financial markets conditions:
  - Government was concerned about the possible effects of the 2008 financial crisis
In March 2008, Costa Rica decided to use contingent line of credits offered by the World Bank (DDOs) in order to implement a strategy to reduce these vulnerabilities.

This strategy materialized in two different projects:

- September 2008: US$65 million project to provide funding in case of natural disasters.
- April 2009: US$500 million project to provide immediate liquidity when the borrower needs it (economic or financial shocks, etc.)
Similar to a line of credit, a Deferred Drawdown Option (DDO) designed for countries with no immediate need for funds...

...but that could face liquidity gap due to an unforeseen event.

DDOs fall under guidelines for Development Policy Lending (fast disbursing, budget support).

1) DPL with Cat-DDO: $65 million
   - Provides immediate liquidity after a natural disaster results in the declaration of a state of emergency.
   - Deferred disbursement of a project from 3 up to 15 years
   - Requires preparation or existence of a disaster risk management program

2) DPL with DDO: US$500 million
   - An immediate source of liquidity when the borrowers need it
   - Deferred disbursement of a project from 3 up to 6 years
   - Periodic monitoring of borrower’s compliance with DPL program and macro-economic framework by the Bank
1) Managing Vulnerability to Natural Disasters in Costa Rica

The Government’s Disaster Risk Management Framework

- The National Risk Prevention and Emergency Management Commission (CNE)
  - It’s responsible for planning, coordinating, directing, and controlling emergency response at the national level.
  - It’s in charge of the initial attention to the affected population; the assessment of damages and needs; the coordination of public entities and the private sector; and the development, contracting and implementation of rehabilitation and reconstruction plans and projects.
- A state of emergency can be declared only by the Executive Power, through a decree that specifies the occurred event, the general characteristics of the crisis, and outlining the areas covered by the declaration.
1) Managing Vulnerability to Natural Disasters in Costa Rica

The Government’s Disaster Risk Management Framework

- The law obliges other institutions and local governments to act under the direction and coordination of the CNE and to attend to the emergency, with priority on ordinary works.

- The main source of financing for emergencies, rehabilitation, and reconstruction is the National Emergency Fund, which is capitalized by mandatory transfers from public institutions and donations from various sources. In particular, the law mandates that all public institutions transfer 3% of their financial surplus or profit to the National Emergency Fund.
1) Managing Vulnerability to Natural Disasters in Costa Rica

**Development Objective**
Before disaster strikes, improve government’s capacity to implement disaster risk management program.

**Financing Requirement?**
Government needed contingent source of immediate liquidity to serve as bridge financing while other sources of financing are secured in the event of natural disaster.

**Risk Management Objective**
Avoid budget reallocations and the disruption to ongoing programs that disaster response would require.
1) Managing Vulnerability to Natural Disasters in Costa Rica

**Identifying risks**

- The timing and financial impact of disasters is unpredictable.
- Unpredictable budgetary reallocations to address disaster recovery can affect other, ongoing programs.
- Repayment schedule for disaster loans difficult to predict and plan

**Financial Solution**

**Catastrophe Risk Deferred Drawdown Option** (Cat DDO) for USD 65 million (0.25% of Costa Rica’s 2007 GDP) may be disbursed (partially or in full) upon occurrence of a natural disaster that causes a declaration of state of emergency.

Cat DDO will provide a source of **bridge financing** while other sources are being mobilized following a natural disaster.
1) Managing Vulnerability to Natural Disasters in Costa Rica

How Costa Rica has used the CAT-DDO?

- In January 2009, just months after securing the Cat-DDO, a 6.2 magnitude earthquake struck, affecting more than 120,000 people.

- To date, Cost Rica has used US$24 million of the Cat-DDO to rebuild damaged infrastructure and mitigate other damages (we didn’t need the funds for the immediate response to the emergency).

- In September 2010 another state of emergency was declared because of floods, so probably we are going to use US$15 million more in a few months.

- The undisbursed balance remains available until the project’s closing date (October 2011). Government has the option to extend closing date.
2) Using Back Up Financing to Boost Investor Confidence in Costa Rica

**Development Objective**

(i) Strengthen public finances and their transparency and (ii) improve competitiveness by enhancing secondary education and facilitating market entry in the telecommunications and insurance sectors.

**Financing Requirement**

- Counter the possibility of adverse economic and financial events that could limit debt market access for Costa Rica.

**Risk Management Objective**

- Government needed a back up financing facility that would signal the availability of resources to capital markets without having to necessarily draw down the loan itself.
During the worse stage of the financial crisis CR managed to fulfill his funding needs through the domestic market, this is, we knew that we had a strong domestic market but uncentatly worldwide made us look for new funding options just in case things were even worse.

Administrador, 10/24/2010
2) Using Back Up Financing to Boost Investor Confidence in Costa Rica

Financial Solution

- USD 500 mm DPL with Deferred Drawdown Option (DDO) provides the country with immediate source of liquidity when needed
- Mitigates the risk of a downturn in economic growth or adverse changes in commodity prices or terms of trade

Costa Rica Needs:
2) Using Back Up Financing to Boost Investor Confidence in Costa Rica

How Costa Rica has used the DPL with DDO?

- Following the Government’s request, the line of credit was prepared in a few months and made available to the government in April 2009.

- Even with and important fiscal deficit during 2009 (3.5%) we didn’t use the DPL DDO. There was uncertainty about the final approval of the Congress (Presidential elections were approaching) so we made all our funding strategy with the domestic market.

- But the market always knew that we had the possibility to use the $500 million from the DPL DDO. This helped us to control pressures over interest rates in the Government auctions.
2) Using Back Up Financing to Boost Investor Confidence in Costa Rica

How Costa Rica has used the DPL with DDO?

- In 2010 we had a different situation:
  - Even though we have been successful in funding Government needs in 2009 and 2010 with the crisis we have an increase in the interest rate risk and mainly in the roll over risk in the debt portfolio.
  - With increase of the deficit we got more debt and so more interest payments that make pressure to the social expenses and to infrastructure investments. The new Government is taking this situation seriously (is pursuing a tax reform) but from the debt management field we can help reducing the interest expenses.
  - We had “room” for more dollars in our portfolio. During the previous years of the crisis and before we had the policy of reduce our share of foreign debt in the portfolio.
  - We got the final approval in the Congress to use the loan.
2) Using Back Up Financing to Boost Investor Confidence in Costa Rica

How Costa Rica has used the DPL with DDO?

- In August 2010, Government of Costa Rica used DPL-DDO to:
  - Replace more expensive debt.
  - Free resources for more important expenses such as social transfers and investment in infrastructure.
  - Improve its debt profile and reduce financial risk to face next year while the fiscal reform is approved.
Annex

Terms and Conditions of IBRD Contingent Lines of Credit (Deferred Drawdown Options)
## DPL with DDO: Terms and Product Structure

| Drawdown/ Fund Availability | Provides immediate liquidity when the borrower needs it  
|                            | Full loan amount is available any time within three years of loan signing, renewable once with RVP approval for 3 more years  
|                            | Macro-economic policy framework must be in place  
|                            | Satisfactory program implementation monitored by the bank  
| Volume/ Optionality | Volume limit equivalent to Fast-Disbursing CAS Envelope  
|                       | The client can choose among the same conversion options (interest rate, currency) that are available for IBRD loans  
| Repayment Terms | Repayment terms can be determined at the time of commitment or disbursement  
|                   | Repayment schedule will commence from date of disbursement  
|                   | Each disbursement may have different repayment schedules  
| Pricing | Same interest rate structure as regular IBRD loans  
|          | But higher fees: 0.75% front-end fee; 0.50% renewal fee  


## DPL with Cat DDO: Terms and Product Structure

| Drawdown/ Fund Availability | Provides immediate liquidity after a natural disaster resulting in a declaration of state of emergency  
|                            | Full loan amount is available for three years, renewable up to four times with RVP approval, for a total maximum drawdown period of 15 years  
|                            | Amounts repaid during the disbursement period will be available for subsequent disbursements  
|                            | Macro framework reviewed at commitment and at renewal  
|                            | A disaster risk management program has to be implemented in accordance with Bank standards |
| Volume/ Optionality         | Maximum size of 0.25% of GDP or the equivalent of USD 500 million (exceptions possible for small countries on case-by-case basis)  
|                            | The client can choose among the same conversion options (interest rate, currency) that are available for IBRD loans |
| Repayment Terms            | Repayment terms can be determined at the time of commitment or drawdown  
|                            | Repayment schedule will commence from date of drawdown  
|                            | Each drawdown may have different repayment schedules |
| Pricing                    | Same interest rate structure as regular IBRD loans  
|                            | But higher fees: 0.50% front-end fee; 0.25% renewal fee |