

How Smart Public
Assets Management
Can Drive the
Post-COVID-19 Recovery

Preparing for a Potential
Emerging Markets
Debt Crisis: A Response
Toolkit

Public Sector
Digitization: Payments
and Receivables Take
Center Stage

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Welcome

to Citi Perspectives for the Public Sector

The impacts of the pandemic are felt far and wide in nearly every part of our lives. COVID-19 has presented a challenge of historic proportions, that continues to shape our outlook for a post-pandemic future. Even as the rollout of vaccination programs begins worldwide, government finances face unprecedented strain. Revenues have collapsed given the sharp economic downturn while health and social spending has soared.



Julie Monaco

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While this year has brought extraordinary challenges, it has also revealed remarkable ingenuity, flexibility and perseverance in the public sector. Public sector organizations' shift to remote working was in most instances seamless and critical services continued to be offered to companies and citizens. Success in combating the consequences of COVID-19 has fostered a 'can-do' mentality that will hopefully deliver benefits for years to come.

One of 2020's hallmarks has been the rapid acceleration of digitization for individuals, companies and the public sector. Technologies such as big data and cloud computing have become crucial to governments around the world. As the public sector invests in digitization, payments and receivables should be a priority as they are a key point of interaction with citizens and organizations, and offer scope to improve efficiency and accountability. Digitization has also proved valuable for donations and disbursements during these times of crisis.

As the world looks beyond COVID-19, smart public assets management has the potential to release hidden value in countries' balance sheets to kick-start economic recovery. Public Sector Investment Funds, such as central banks, public pension funds

and sovereign wealth funds, are rethinking their approach to safety, liquidity, risk and reward, in order to meet their obligations in the coming years. And new financial tools can enable central banks to extract greater value from their gold holdings.

The world still faces great risks from the pandemic and its economic consequences, but we believe that creative thinking and a concerted effort to bring multilateral development banks and investors together could head off a potential emerging market debt crisis. Already, multilaterals are helping borrowers to better insulate themselves from global events and systemic shocks. In Europe, COVID-19 has spurred a renewed sense of solidarity that could finally overcome the region's structural challenges.

One cannot overstate how uniquely challenging 2020 was, and we at Citi are proud to serve as a partner and trusted advisor to our clients during these times of uncertainty. This 2020-21 edition of Citi Perspectives for the Public Sector leverages our public sector banking team's expertise to highlight solutions to pressing problems and opportunities to build back better. We hope you enjoy it, and wish you a wonderful year ahead.

How Smart Public Assets Management Can Drive the Post-COVID-19 Recovery

Countries need cash to survive the fallout from COVID-19. By tapping hidden value in their balance sheets, they can exit the crisis faster and more sustainably. But success depends on strong political will.

What does 'generating value from the balance sheet' mean in practice for the public sector? Governments everywhere and at every level own a vast array of commercial assets. According to the IMF, the value of public assets globally is twice that of global stock markets, twice global GDP and much larger than public debt.¹ However, unlike listed equity assets, this public wealth is often unaudited, unsupervised, and unregulated. Even worse, in most countries it is almost entirely unaccounted for.

As a consequence, when formulating their budgets, most governments largely ignore the assets they own and fail to recognize that they could generate substantial yields that open up much-needed fiscal space. Governments could use this headroom to kick-start growth or to buffer themselves from future shocks, without resorting to debt, exhausting existing savings, or being forced to revert to excessively painful austerity measures.

However, incentives to encourage policymakers to take into account the full spectrum of public commercial assets – such that the whole public sector balance sheet can be marshalled to achieving economic recovery – are often missing.

Basic tools such as accrual accounting, that are fundamental building blocks to bring about greater transparency and disclosure (of benefits as well as costs), can enable governments to pursue optimal decisions with respect to the management of public assets, benefiting society. Yet these tools are often overlooked. Is the COVID-19 crisis enough to induce governments to finally act?



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4 What does 'generating value from the balance sheet' mean in practice for the public sector?

¹ <https://www.imf.org/en/Publications/FM/Issues/2018/10/04/fiscal-monitor-october-2018>

What is not measured does not count

Cash accounting focuses on a few narrow and unrepresentative numbers; it has led to chronic under-investment in, and under-management of, valuable publicly owned assets. Accrual accounting is consistent with the IMF economic framework for fiscal policymaking; it is almost two decades since the IMF shifted its manual for Government Finance Statistics (GFS) from a cash to an accrual basis. Many countries are following suit, with the Chartered Institute of Public Finance and Accountancy (CIPFA) and the International Federation of Accountants (IFAC) predicting that almost two-thirds of governments around the world will have moved to accrual-based accounting within the next five years.²

But even when countries make such a change to their accounting systems, they often do not go far enough to reap the full benefits. They fail to use the information those systems produce in their fiscal decision making. Why?

In most cases, the political will required to manage public assets better – to provide full disclosure of these assets and to create the incentives to encourage policymakers to act – has been lacking, as the immediate gains were not obvious. In the current urgent circumstances, with so many lives and livelihoods at stake, the case for better stewardship of public assets could not be more pressing.

Capital Charge

A perennial problem of financial management in the public sector is poor asset utilization, which can be most obviously seen in decaying infrastructure. An incentive for better management can be created through the use of a capital charge, which requires government organizations to meet the cost of the capital they employ. The charge rate reflects the opportunity cost to taxpayers of having resources invested in government assets. For example, the New Zealand Government levies a charge of 6% of the net worth (assets less liabilities) of their departments.

This means the measured cost of services includes all costs, and so is better able to be compared with alternative external providers, and it also provides departments with an incentive to dispose of assets that are not productive and to better manage the structure of their balance sheets.

Why incentives matter

In any organization, including a public financial management (PFM) system, decision makers respond to a broad set of incentives. It is therefore critical that incentives are designed to encourage the right decisions and actions.

Key decisions and actions within a PFM system include:

- major financial and other policy decisions, such as privatizations;
- resource allocation decisions, whether capital or operating;
- revenue-raising decisions;
- financial control decisions in an operating context; and
- asset management decisions.

Incentives should encourage decisions that are aligned both across an organization as well as vertically. For example, fiscally-responsible decisions at an aggregate level should be supported by efficient management of service delivery, including asset utilization, at the operational level.

There are, of course, a wide range of factors that create incentives for better – or worse – decisions. These include governance arrangements, transparency requirements, budget systems, processes and rules, assignment of authority for budget and spending decisions. These incentives may be formal or informal. For a fiscal management system, key incentives relate to how financial performance (flows) and financial position (stocks) are defined and measured.

The goal is to align the interests of managers, investors, financial intermediaries, politicians and the general public. Key to this is the use of measures that reflect performance and position in a comprehensive and reliable manner – this is where proper accounting comes in. ‘Proper’ in this context means accounting that fully reflects all revenues and expenses, as well as the range of physical and financial assets and liabilities. Where key decisions are made on the basis of information only about cash flows and debt, there is an incentive to substitute future cash inflows for present ones given the political significance of reported current performance. Perhaps the worst example of this is where future pension benefits are substituted for current wages, which subsequently has the effect of building ever-increasing liabilities that can, ultimately, become unsustainable. Were the performance measures to recognize the incurrence of liabilities, rather than just the cash outlay, the costs of pensions would be recognized in the year the work was done, rather than the year the pension was paid. The consequences of basing key financial decisions on cash flows can be seen in the pension problems faced by many governments.

Accrual based-budgeting: The missing link

The current status of accounting within the PFM systems of governments can be characterized as follows:

- many governments budget, make appropriations and report on a cash basis;
- some governments budget and appropriate on a cash basis, but then report on an accrual basis;

- relatively few budget and report on an accrual basis, but appropriate on a cash basis;
- virtually none budget, appropriate and report on an accrual basis.

The decoupling that occurs with accrual reporting and cash-based budgeting largely defeats the purpose of moving to accruals. In order to achieve the right incentives and signals, it is necessary to align the concepts and metrics used in reporting (ex-post) on performance, and those used in stating the expectations (ex-ante) – budgets and appropriations. Budgets and appropriations cannot fully reflect the resources used by governments unless they are also on an accrual basis and capture all the assets and liabilities on the government’s balance sheet. In effect, a PFM system that is based only on cash flows and debt ignores critical assets (especially physical assets) and non-debt liabilities (such as public sector pensions) and is therefore inadequate for managing the complex financial operations of modern government.

Those governments that have progressed to reporting on an accrual basis but still budget and/or make appropriations on a cash basis face two significant problems. First, their reporting does not align with their budgeting and appropriations, creating misaligned signals and incentives and, frequently, a sense that the move to accrual reporting was not worth the effort. Second, and more importantly, their budgets and hence their operational decision making continue to effectively ignore the management of assets and liabilities that are not cash or debt. In contrast when budgets are on an accrual basis, it is possible to get a clearer view of the real cost of providing services – which includes such non-cash elements as depreciation or asset impairment – and this in turn provides a more economically realistic picture of value for money, enabling comparison with the cost of providing similar services from an alternative supplier. Such comparisons provide an incentive to consider the value for money of the specific service, encouraging a greater focus on operational efficiency.

Making major financial decisions and budgeting on the basis of accrual information enables decision makers to see the planned impact

New Zealand and COVID-19

The New Zealand Government has had a PFM system with accrual numbers at its core for three decades. During that time, its fiscal position has progressively strengthened (apart from the four years following the global financial crisis and the Canterbury earthquakes) from a position of negative net worth to one, just prior to COVID-19, where net worth was equivalent to just under 50% of GDP.

The Government's COVID-19 strategy took advantage of the strong fiscal position to "Go early, go hard", leading to the effective elimination of the disease and less than thirty deaths. A strong balance sheet, a good health system and a competent state sector have dramatically contained the human impact of the pandemic.

of a year's activities on the net worth of the government – net worth being the most comprehensive measure of fiscal position. For example, a privatization might enable the reduction of debt relative to GDP; however, unless the asset is sold for more than its balance sheet value, the privatization will reduce net worth and the government's balance sheet strength.

The value of a balance sheet approach to fiscal decision making is increasingly being recognized. The work of the IMF, reported in the October 2018 Fiscal Monitor, was a major step forward in this respect.

One of the significant potential benefits of using accrual accounting and a balance sheet approach to public financial management is the attention it focuses on the assets on a government's balance sheet, encouraging more reliable information on what assets the government owns and what those assets are worth, and better systems of asset management.

In response to COVID-19, governments have taken a greater role in their economies and increased the size of their balance sheets, yet their fiscal positions are more fragile than before. Under these circumstances, the value that can be extracted from the assets held by governments will become increasingly crucial, whether it is in the revenue generated by commercial assets or the services provided by assets that are held for public policy reasons.

Interacting with the private sector 'wall of money' on equal terms

The weight of international evidence is that government ownership is generally inefficient compared to private ownership in terms of corporate economic performance.³ On average, government-owned operational assets are a third less productive than private firms'.⁴ This diminished productivity hampers economic growth, creates waste, and tends to drive an overreliance on a narrow base of taxes as the major source of government revenues. The most reasonable explanation for the relative underperformance of government-owned operational assets lies in weak governance practices arising from opposing objectives, poor incentive structures, political interference and the lack of public scrutiny.

But if public assets – meaning public commercial assets, rather than public parks or historical heritage sites – were properly accounted for and professionally managed, they could potentially generate additional revenues worth 3% of GDP, boosting government budgets.⁵ Managing these assets better could help offset the growing debt problem facing many governments and support future economic growth, while the additional yields could help fund public goods such as public housing, health care and infrastructure, or even R&D to mitigate the impacts of climate change.

Realizing value from public assets

The largest segment of any portfolio of public commercial assets is real estate. Government-owned commercial real estate assets account for a significant portion of each country's land. But governments typically know about only a fraction of these properties, as they do not have a comprehensive list of the assets nor even a proper underlying cadaster or land registry, a system that defines the dimensions, locations and titles of all land parcels.⁶

Even in an economy such as the United States that is perceived as having a relatively small public sector, the indicative valuations of public real estate in urban areas is substantial.

In the case of Pittsburgh, for example, the difference between book value and indicative value was 70 times, according to one analysis.⁷ If professionally managed, this real estate portfolio could generate an additional income well beyond what the city raises in taxes today.⁸

European countries have experimented with managing public wealth for a wide range of different purposes, and with varied results, for almost a century. Sweden became the first country in Europe to introduce active management of public assets with a clear financial purpose. Instead of wholesale privatization, the Swedish government decided to manage the public portfolio "as if owned by private shareholders."⁹ This Swedish experiment from 1998 to 2001 included introducing private sector discipline and an equity culture to the management of public assets, and boosted the value of the portfolio by 12% over the three-year period, or almost twice the growth of the local stock market during the same period, resulting not only in a better outcome from vital services but also a substantial dividend to the government, as well as a boost to economic growth.¹⁰

By deploying a similar model, Solidium, Finland's National Wealth Fund, has generated a total return on equity of 8% per annum, and the value of its equity holdings has increased from €5.5 billion to €5.7 billion since 2008, while €5.9 billion was paid as a dividend to the state during the same period.¹¹

At local government level, Hamburg and Copenhagen have both learnt lessons from MTR, the Hong Kong railway company that built an entire subway system the size of New York City by developing the properties adjacent to its stations rather than via taxes.¹² Through their respective Urban Wealth Funds, these two cities have developed tens of thousands of new residential housing units, hundreds of thousands of workspaces and education facilities, as well as new parks and retail and cultural facilities. With the financial surplus from its operations, Copenhagen was even able to help fund part of the extension of the local metro system. Similarly, London Continental Railways (LCR) and Jernhusen (in Sweden) have successfully developed areas around train stations in cities, without using taxes.

While most of these examples come from developed markets, the concept and operational steps are readily applicable to the emerging markets. As a prime example, professional use of public commercial assets was a core component of Singapore's strategy to move the economy from developing to developed status in a single generation.¹³

How to manage public assets professionally

A public wealth fund (PWF), structured as an independent holding company, can be set up to manage commercial public assets. Using the same tools of financial management as the private sector, a PWF makes it possible for the government to maintain ownership and manage assets professionally, while interacting with the private sector on equal terms. It should

³ Megginson, W. and Netter, J. 2001. "From State to Market: A Survey of Empirical Studies on Privatization." *Journal of Economic Literature*, 39 (2): 321-389.

⁴ <https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>

⁵ <https://blogs.imf.org/2019/06/18/a-global-picture-of-public-wealth/>

⁶ <https://www.imf.org/external/pubs/ft/fandd/2018/03/pdf/detter.pdf>

⁷ Valuations made by Urban 3.

⁸ <https://www.imf.org/external/pubs/ft/fandd/2018/03/pdf/detter.pdf>

⁹ Financial Times, Nov 12 1999

¹⁰ Detter, D. and Fölster, S. (2015) *The Public Wealth of Nations*

¹¹ <https://solidium.studio.crasman.fi/file/di/i/2DHkMA/j3nr0dWCYA-HZDZJiYjTIQ/Solidiumcorporatepresentation20200331.pdf>

¹² <https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/the-rail-plus-property-model>

emulate the best international standards of listed companies including those pertaining to corporate governance, transparency and incentive structures.

The PWF would serve as the conduit between public and private sector interests, enabling the two sides to speak the same language and to reach a consensus on objectives. It could help sidestep common problems seen with privatizations, PPPs and other financial techniques where the public sector seeks to avoid the commercial risk and debt associated with an investment, thereby giving up the financial upside resulting in an undue transfer of public wealth to the private sector. The structure might therefore help avoid the political backlash that often stems from the interface between the public and private sectors. The establishment of the holding company structure could also better attract

private sector funds looking for yield, thereby drawing in the additional resources and expertise needed to help a country or a city develop.

In setting up a PWF, a government needs to pay special attention to three fundamental principles given the inherent weakness of public sector corporate governance, including:

- **Value maximization:** This must be the sole objective; additional objectives distort competition and open the door to financial failure, waste and corruption;
- **Promoting transparency:** Accounting, transparency, risk management and corporate governance standards should be identical to those for a listed holding company, including the adoption of IFRS accounting and the provision of timely quarterly and annual reports, made available online;

Impact on Sovereign Ratings

Could better ratings (which could lead to reduced borrowing costs and potentially greater foreign investment) be a driver for policymakers to pursue the steps outlined in this article to improve the management of public commercial assets?

Unfortunately, the ratings methodologies of the three global rating agencies – S&P, Moody's Investors' Service, and Fitch Ratings – do not incorporate the net worth of the public sector, in large part because they do not have visibility into the full scope of the public sector balance sheet. Since governments do not produce a complete and consolidated picture of all their assets and liabilities, within the proper accounting framework to provide transparency, the agencies do not have the means to make an assessment.

As the rating agencies do not take public sector net worth into consideration in their assessments of sovereign creditworthiness, governments do not in turn produce balance sheets. This Catch-22 situation could potentially be overcome with an external push, perhaps exerted by the IMF were it to conclude that the full public sector balance sheet should be the proper basis for its debt sustainability analysis.

Nonetheless, better management of public assets could still help governments improve their ratings, albeit indirectly and in most cases over a long time span. It is also possible that producing a full set of financial statements could help avoid a downgrade, as was the case for New Zealand in 1991.

¹³ https://www.citibank.com/icg/docs/1883952_Perspectives_2019_Putting_Public_Assets_to_Work.pdf

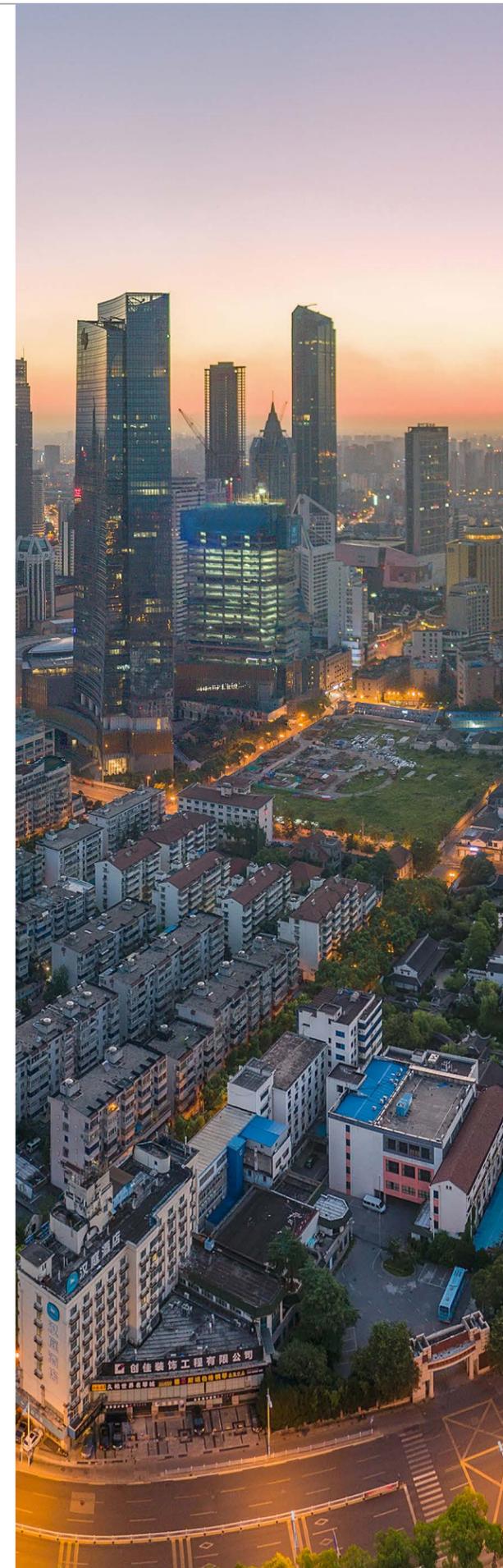
- **Ensuring political insulation:** The portfolio should be kept at arm's length from political influence, including avoiding political appointees at every level (as well as on the board and supervisory board levels). This arrangement serves as a protection and deniability for the politicians, if trouble arises. Commercial independence is also the best foundation to attract qualified people from the private sector. A market-based incentive system is vital, but a secondary consideration to a truly professional environment.

Once a PWF is established, its first task is to develop a feasibility study, or asset map, of the entire portfolio of public commercial assets within the relevant jurisdiction. Such an indicative valuation would give a rough understanding of the total value, as well as of the potential yield (assuming professional management), of the assets. The asset map should not take more than a few months to produce, as its main purpose is to create political momentum and a rough business plan.

Conclusion

Comprehensive and relevant numbers are a prerequisite for financial management. A modern government is a highly complex institution that requires audited numbers and accrual accounting to ensure informed and sustainable long-term decision making and management. Moreover, using the hidden strength in their own balance sheets offers governments a better chance to achieve a sustainable and faster way out of the current crisis, to the benefit of society as a whole.

The hurdles to adoption of tools such as accrual accounting, and the political will to act on the information generated by such systems, has historically been lacking in most countries. For years, the price of inactivity and an absence of imagination in many countries could be discounted. However, the pressures created by the COVID-19 pandemic, which are likely to strain public finances for a generation, demand radical action. Given that the alternative in many countries could be a prolonged period of austerity, rethinking how governments view public assets is now a moral goal, as much as an economic one. Making this change will be difficult for governments in both developed and developing countries. But the evidence is clear: commercial management of assets by a PWF delivers material gains. This time of crisis calls for the most effective use of public assets – if not now, when? ■





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Public Sector Investment Funds, including central banks, public pension funds and sovereign wealth funds, account for over half the world's professionally-managed assets.

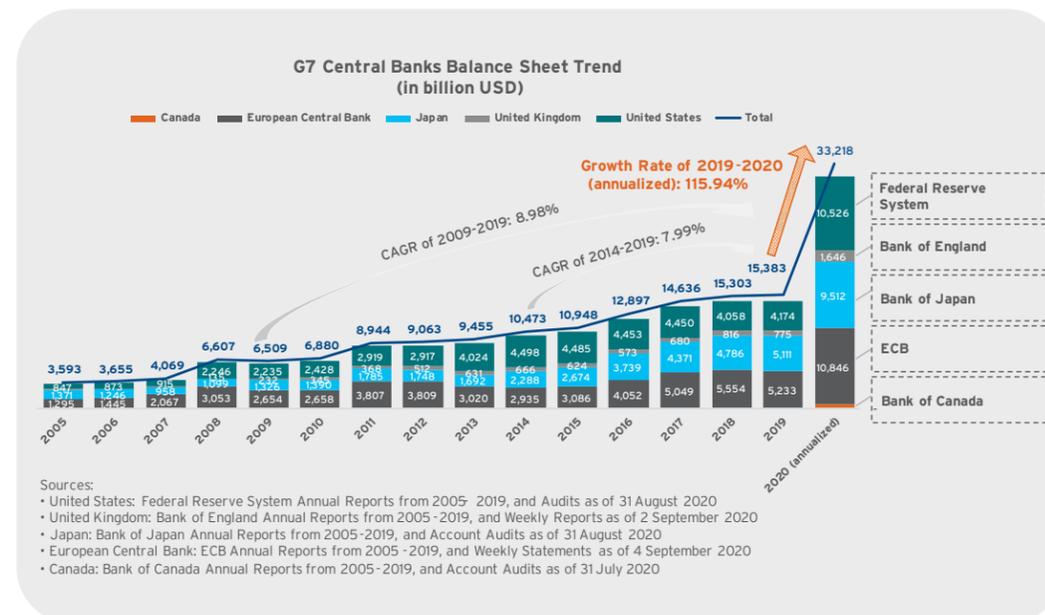
Investing Post-COVID-19: Challenges and Responses

Public Sector Investment Funds, including central banks, public pension funds and sovereign wealth funds, account for over half the world's professionally-managed assets. In this article, we outline ways that they can respond to today's challenges, many intensified by the COVID-19 crisis, and highlight practical approaches to help navigate this evolving and complex risk environment.

Central bank balance sheets were near record highs before the onset of COVID-19; most were not meaningfully reduced as the global economy recovered following the Global Financial Crisis (GFC), and some continued to expand over the past decade (see fig. 1). Now, in an effort to combat the economic disruption caused by the COVID-19 crisis, central banks around the world are engaging in monetary easing at an unprecedented rate and scale, swelling balance sheets to levels almost unimaginable 12 months ago.

Fig. 1: Central Bank Balances Failed to Shrink After the GFC

As part of efforts to encourage banks to lend and stimulate growth, a number of central banks have implemented negative interest rate policies, which has had far-reaching consequences for sovereign debt. At \$17.9 trillion at the end of September 2020¹, the volume of negative yielding sovereign debt globally is nearly three times the level of late 2018² (fig. 2) and is 31% of total outstanding sovereign debt¹. Indeed, there is even more negatively yielding debt in real terms.



Sources:
 • United States: Federal Reserve System Annual Reports from 2005-2019, and Audits as of 31 August 2020
 • United Kingdom: Bank of England Annual Reports from 2005-2019, and Weekly Reports as of 2 September 2020
 • Japan: Bank of Japan Annual Reports from 2005-2019, and Account Audits as of 31 August 2020
 • European Central Bank: ECB Annual Reports from 2005-2019, and Weekly Statements as of 4 September 2020
 • Canada: Bank of Canada Annual Reports from 2005-2019, and Account Audits as of 31 July 2020



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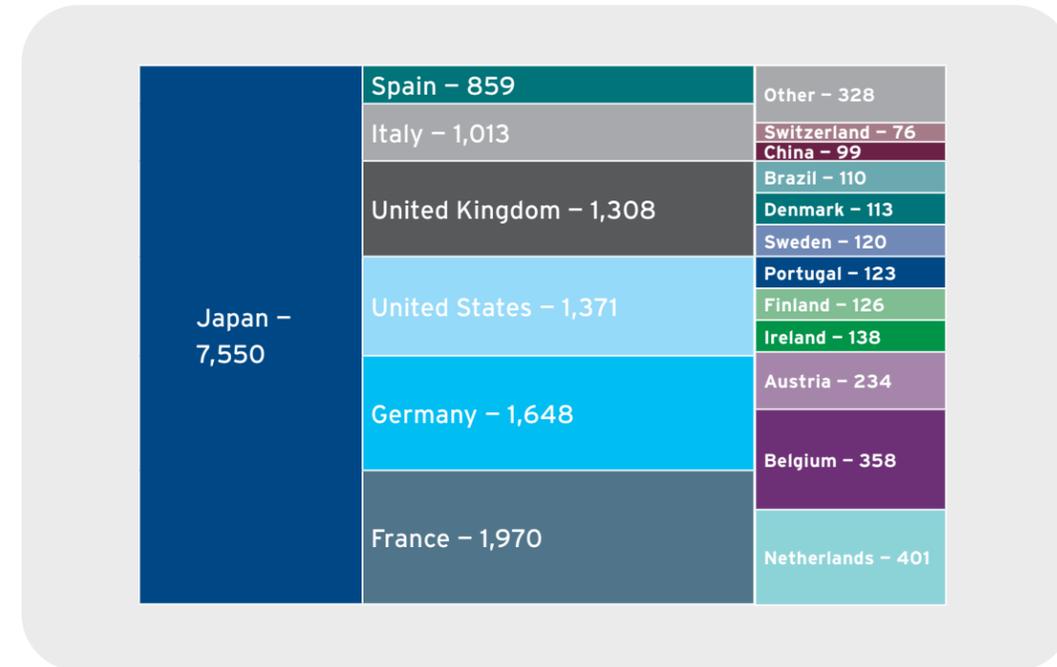
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Fig. 2: Negative YTM - Sovereign Debt (USD billion)

A total of 45 countries have negative yielding sovereign bonds, worth US\$17.9 trillion¹



Source: Bloomberg

Anemic growth prospects and low confidence given the uncertainties surrounding the pandemic suggest that government and central bank stimulus measures will continue for a considerable time. Against this backdrop, many expect yield generation to become ever more difficult and the trade-off against risk increasingly challenging.

That poses a problem for public sector investment funds (PSIFs), which, like all investors, have a duty to meet a range of current and future obligations and liabilities. The scale of their problem is especially significant, however. PSIFs, which include central banks (CBs), public pension funds (PPFs) and sovereign wealth funds (SWFs), collectively manage close to \$50 trillion - over half the world's professionally managed assets; PPFs manage around \$30 trillion, followed by CBs and SWFs with \$12 trillion and \$8 trillion respectively.

Negative yields create asset allocation problems

How can PSIFs manage their assets in a near zero rate environment where historical allocations and strategies have been undermined by the structural shift in the investment landscape? There is no one-size-fits-all approach, as the starting point for each individual PSIF is different. Moreover, liabilities aside, the different groups have distinct asset mixes.

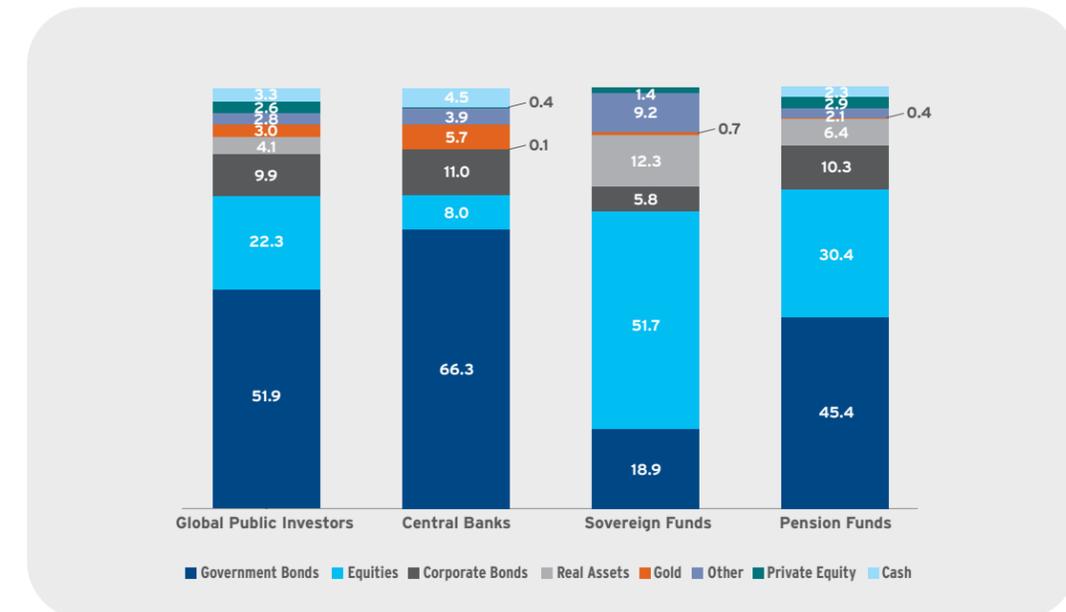
Overall, PSIFs have more than 50% of their assets in sovereign debt, reflecting the competing priorities of safety, liquidity, returns, regulation and their mandates. However, allocations vary significantly (fig. 3). CBs have the largest exposure to sovereign debt (66%) as safety and liquidity remain their overriding considerations, while SWFs have the lowest exposure. PPFs, with their unique set of liability-matching obligations, hold just under 50% of their assets in government bonds; they face the greatest immediate challenge from the current yield environment.

¹ Bloomberg, September 24 2020

² <https://www.nytimes.com/2020/05/13/business/economy/china-tsp-federal-retirement-fund.html>

After government bonds, equities account for the second largest allocation, with almost 25%. These are concentrated in SWFs and PPFs; corporate bonds are third with about 10%. The remaining 15% includes a variety of other investment types, although allocations vary greatly between the categories.

Fig. 3: Global Public Investors' Asset Allocation Snapshot % of Portfolio (2019)



Source: OMFIF 2020 report

PSIFs face a wide range of financial and economic challenges

Even before the COVID-19 crisis, the period of prolonged low interest rates following the GFC was squeezing returns. Globalization, more integrated markets and numerous other factors have made it harder to diversify as inter-market correlations have risen over the past 30 years. At the same time, equity indices are shrinking and fewer private firms are going public. Those that do list are taking much longer to IPO, leading to reduced opportunities for investors in public markets, and particularly for those investing in index funds.

The COVID-19 crisis has exacerbated many of these trends and created additional challenges. There is now greater uncertainty, higher volatility and more intense competition for assets and returns. Valuations are even harder to interpret given the amount of liquidity provided and the various asset purchase programs implemented by central banks. Consequently, asset prices provide less information about risk and return. At the same time, there are rising expectations around responsible and sustainable investing despite the criteria for these types of assets being ill-defined.

There are many risks, both old and new, for PSIFs to take into consideration as the world recovers from the pandemic. Ironically, in such a low yield environment, inflation may be one of the most significant risks. The new policy announced by the Fed in late August 2020 - allowing higher levels of inflation for longer to make up for failure to meet past inflation targets - signals that inflation is less of a threat from a policy perspective. However, the same may not be true from an investing perspective.

Given the unprecedented scale of the COVID-19 crisis, governments are turning to PSIFs to fund emergency measures and drive a sustainable recovery.

Inflation tolerance is likely to shift over time. The effect of increased inflation expectations and the emergence of actual inflation could fundamentally change the investment landscape after years of monetarist central bank orthodoxy, which prioritized fighting inflation. The vast amount of liquidity poured into the global financial system over the past 12 years, and particularly the amount injected during 2020, may prove problematic. Milton Friedman's observation that "inflation is always and everywhere a monetary phenomenon" will continue to echo through markets and policymakers' minds. Inflation may be a significant risk in the years ahead, and one that needs to be managed appropriately by all investors, but especially those with longer horizons such as PSIFs.

Political challenges risk undermining long-term goals

Given the unprecedented scale of the COVID-19 crisis, governments are turning to PSIFs to fund emergency measures and drive a sustainable recovery. These are worthy public policy goals but may be planting the seeds of future problems; the implications may even run contrary to the best interests of pension scheme members and SWFs. With governments' debt-to-GDP ratios surpassing their post-WWII record, there is little room to top up public pension funds if returns cannot meet liabilities – either tomorrow or in 20 years (regardless of whether that deficit is a result a function of low returns, high expectations, or inflation exceeding benefit caps).

Record debt-to-GDP ratios are likely to prompt an increase in public/private partnerships. However, these are not a panacea and are frequently more complicated in practice than in theory. There can often be more effective alternative solutions, but these require breadth of expertise, imagination and genuine partnership between clients and advisors to design and successfully execute.

Political involvement, both broadly in such areas as trade, supply chains, and stock listings, and narrowly, such as not allowing the U.S. Government Employee Pension Fund to invest in China³, increases challenges for

PSIFs considerably. All public investment funds ultimately exist in the political sphere as well as the financial, and the degree of freedom and independence they enjoy are neither constant nor absolute. This is especially the case given that unavoidable government spending in response to the COVID-19 crisis is creating a mountain of future debt, and pre-COVID-19 austerity policies may be politically untenable in the future. Navigating through these unsettled seas will require PSIFs to exercise considerable skill and utilize a range of tools and approaches.

Potential impact on asset allocation

Given the financial, economic and – to a lesser extent – political challenges facing PSIFs, they are likely to allocate more capital to assets that are expected to produce higher returns.

Put simply, we anticipate significantly increased allocations to equities, corporate bonds and a variety of other, less liquid, investments, particularly by PPFs and SWFs. While the two groups encompass a variety of investment horizons, these are on average considerably longer than the market at large. This affords relative freedom and the capacity to look through shorter-term market upheavals but will result in even greater competition for high quality assets in both private and public markets.

There are limits to the extent that PSIFs can chase yield, however. Their problems cannot be solved simply by amending asset allocation. At least part of the solution lies in how capital is put to work and allocated, how risks are managed, and how efficiently the different components of the portfolio are married together.

Rethinking safety, liquidity, risk and reward

PSIFs face a range of significant challenges. However, they also have a great opportunity to reconsider their approaches to safety, liquidity, risk and reward in order to meet return obligations within the boundaries of their mandate. To do this effectively, it can be invaluable to enlist external support.

Citi has deep experience guiding and partnering PSIF clients to design effective and creative solutions to achieve tailored return outcomes, reduce and transform risk, increase operational efficiency and decrease cost and complexity. Citi's unrivalled global footprint, expertise and long history in advising on, and executing capital flows – from markets and banking, to treasury and trade – gives us the ability to assist public sector funds investing anywhere in the world.

Below are some examples of capabilities that Citi can draw on to construct solutions that meet individual PSIF client problems.

- Access to Global and Local Markets: Ability to reliably execute across assets and markets in a variety of liquidity conditions.
- Access to a Broad Range of Investment Opportunities: Insights on public market investment trends, themes and strategies in all regions; connecting long-term investors to corporates keen to divest assets; navigating emerging channels to deploy capital, such as special-purpose acquisition companies, so-called 'bad bank' structures; entities to manage non-performing loans, and private secondaries.
- Yield Enhancement: Securities lending, return-enhancing solutions for gold.
- Customized Hedging and Diversification Strategies: Bespoke risk management for rates/credit/FX/commodity hedging.
- Managing Inflation Risks: Public and private assets, e.g., TIPS and other inflation-linked securities; hard assets including real estate, timber, agricultural land, art, etc.
- Portfolio Protection and Transition: Environmental, Social and Governance advisory for transitioning businesses and portfolios to sustainable investments.
- Resource Optimization: Balance sheet and collateral optimization.
- Asset Servicing: Custody and securities services.

- Business Advisory Services and Global Data Insights: Strategic and technology consultancy regarding investment industry evolution and emerging fintech companies.
- Payments: Domestic and cross-border payments and FX.

Conclusion

Public sector investment funds, custodians of \$50 trillion of investable assets, face many daunting challenges given the changes in the economic and financial landscape. Low or negative interest rates on sovereign debt, political pressures, COVID-19 and potential inflation risks add considerable complexity, but do not change PSIFs' fundamental imperatives of investing for safety, liquidity and return.

Among PSIFs, public pension funds arguably face the greatest challenges given their explicit stream of growing liabilities, but similar challenges are common to all PSIFs. Tactical allocations will change over the coming years in search of higher yields and less crowded or less efficient markets, where there may be greater opportunities.

Citi is committed to helping our PSIF clients navigate these challenging times and achieve their objectives of enhancing returns, reducing risk and improving efficiency. Our unmatched global presence, long experience in the public sector, and breadth of solutions and services make us ideally placed to meet your needs and deliver solutions to address a range of opportunities and problems. Our global team stands ready and we look forward to discussing how we can help. ■

³ <https://www.nytimes.com/2020/05/13/business/economy/china-tsp-federal-retirement-fund.html>

Public Sector Digitization: Payments and Receivables Take Center Stage

Governments around the world are increasingly recognizing and harnessing the benefits of digitization. Payments and receivables should be a priority as they are high touch for citizens and companies, offer efficiency gains, and enhance accountability.

Digitization has become a key focus for state and municipal governments around the world. They, like companies across all business sectors, are assessing and implementing potential use cases for innovative technologies such as big data (for example, fraud detection), the cloud (data security), deep learning (to eliminate manual invention), and distributed ledgers (to deliver a robust registry) and myriad other innovations. The potential economic, social and governance benefits are significant.

Digitization has the potential to increase economic growth, promote innovation and modernize infrastructure. It can improve convenience and choice for citizens while fostering social cohesion and inclusion. By putting a spotlight on governance in the public sector, digitization can lead to service improvements and increased resiliency, transparency and risk management, cost optimization and help drive inclusive growth.

As a result, digitization is seen as a key way to address longstanding challenges facing governments, including corruption, inefficiency, cumbersome bureaucracy and red tape, and citizen distrust and disengagement, which are often paradoxically paired with rising citizen expectations.

Governments' efforts to adopt digitization are being accelerated in the wake of COVID-19. In the immediate term, many governments are seeking efficient ways to channel funds to citizens or businesses. Given the sharp fall in economic growth, digitization is also seen as a catalyst for recovery: the UK could add 4% to UK GDP by 2030 by implementing digital IDs, for example. At the same time, governments know that the long-term costs incurred in overcoming the pandemic are unsustainable: new tools to drive efficiencies must be implemented to hasten the recovery.



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Digitization has become a key focus for state and municipal governments around the world.

¹ <https://www.mckinsey.com/business-functions/mckinsey-digital/our-insights/digital-identification-a-key-to-inclusive-growth>

Why payments and receivables are important

Payments and receivables are a crucial way in which governments interact with corporations, small and medium-sized enterprises and citizens. Changes in technology, payment solutions and business and consumer payment behavior mean that digitization of government payments and receivables should be a priority as governments seek to advance their digitization agenda.

1. Instant payments offer a new way to engage

Having gained traction more than a decade ago in countries such as the UK, instant payments have now spread to 55 markets worldwide: 85% of the world (as measured by GDP) either has instant payments or will implement programs within the next 12 months.

The applications for instant payments in the public sector are numerous. In the UK, for example, taxpayers no longer need to worry about planning their income tax payments days in advance of the official payment deadline. Instead, they can simply make an online payment at any point until midnight on the day the payment is due. Similarly, local government charges or fines can be paid instantly, even by those without a credit card.

All governments are focused on the need to further enhance their ability to collect and pay in real time on a 24/7 basis to replace cash, check and card in order to lower costs and improve convenience.

Crucially, introducing digital payments gives significant additional choice to payers. Instant payments are just one option among many - digital wallets such as Ali Pay, Apple Pay and Google Pay can also be made available, giving citizens the flexibility to pay by their preferred method.

2. Digitizing payments can underpin broader process improvements

The visa process for many countries is lengthy and complicated. To apply for a US visa, for example, in many countries applicants must first fill out forms before visiting a bank branch to pay by cash or check; the payment is then sent to the Department of State, after which an appointment is made.

By digitizing the end-to-end process, it can be significantly accelerated, improving convenience and lowering costs. For instance, the application form can be filled out online and the applicant then seamlessly taken to a portal where they make a frictionless payment before an appointment is automatically scheduled. Parking fine payments are another potential use case for digital payments that would help to drive broader process improvements. A digital payment could prompt the automatic delivery of a code that enables the payer to unlock a parking boot placed on a car wheel. This would avoid the need to go to the car pound to collect the car or search for a parking officer to remove the boot.

3. Digital payments overcome cross-border challenges

Cross-border payments and collections can be expensive and challenging for governments to manage. For example, New Zealand provides loans to its citizens to study abroad. Frequently, students continue to reside in the country where they studied (while others emigrate from New Zealand after college). When they want to begin repaying their loans, these students must make cross-border payments, incurring high payment and FX costs; FX conversions and fees also make it difficult to send required exact amounts. This is inconvenient for the payer, who has to pay retail FX rates, and causes reconciliation challenges for the public authority entity collecting the payment.

New solutions enable individuals resident in other countries to pay in their preferred currency while ensuring government agencies receive exactly the amount invoiced or requested in their functional currency, eliminating reconciliation problems. They also allow public authorities to make cost effective payments - for tax refunds, for example - to local bank accounts of citizens resident overseas.

4. COVID-19 has elevated the importance of eliminating paper

Tax collection in many countries involves the use of lengthy paper-based forms as well as payment by check or cash, either to a designated bank or directly to a public authority. In the past, efforts to digitize tax forms and payments have largely been driven by the need to improve convenience, efficiency and transparency. However, in the wake of COVID-19, efforts to eliminate paper - and minimize physical contact - have been given a new impetus. Social distancing and other restrictions mean that handling of cash and paperwork is potentially risky.

Digitization is a big job - but help is available

The economic, social and governance gains available from digitization are significant. But implementation can be challenging for governments and public sector entities. Necessarily, it involves potential upheaval and process change, as well as possibly redeployment of employees and investment requirements. Digitization also creates new risks, such as cyber threats, that need to be effectively managed.

Moreover, to deliver genuine benefits, digitization must be approached in the right way. Many governments have learned from painful experience that digitization requires focused attention and leadership. A single person should be appointed (and empowered) to take ownership of government digitization to ensure it is applied uniformly across departments and agencies rather than via a scattershot approach, where entities make independent uncoordinated decisions.

More generally, governments need to take a holistic approach to digitization. India is one of the best examples of the benefits of adopting such a policy. The country's Aadhaar digital ID scheme, which uses biometrics and has 1.2 billion users, provides a common platform that has been integrated with government financial and social inclusion programs and the UPI instant real-time payment system developed by the National Payments Corporation of India. It is also important that governments lead by example, both in how they implement digitization and in adopting new solutions as they become available. The UK rapidly adopted instant payments for income tax payments, for example, encouraging familiarity and trust.

Fortunately, governments and the public sector do not have to face the challenges associated with digital technologies alone. They should seek support from a bank that has the global footprint to connect them to multiple networks - both geographically and in terms of products, including cards, wires, ACH, instant payments and digital wallets. The use of a consistent offering that leverages a single point of entry can increase efficiency, improve visibility and lower costs. Governments should aim to partner with a bank that can offer support and advice, helping to review end-to-end processes in order to realize the potential gains from digitization. ■



COVID-19 Catalyzes Digital Donations and Disbursements

Crowdfunding and mobile money have a critical role to play in helping multilateral development organizations working to address the impact of the pandemic on the world's poorest countries.



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The COVID-19 pandemic and emergency measures to control it, such as lockdowns and travel restrictions, have dramatically impacted lives and livelihoods around the world. By the end 2020, there were millions of infections and over one million deaths;¹ the economic shock is estimated as three times greater than the 2008 financial crisis.² And with a vaccine not arriving soon enough for all, disruption and hardship are expected to continue for some time.

The United Nations (UN) has called for solidarity and increased funding, launching a \$2 billion global humanitarian response plan to fund the fight against COVID-19 in the world's poorest countries.³ However, multilateral development organizations working in humanitarian contexts also have a key role to play in helping the world to alleviate the impact of the pandemic and recover from its economic consequences.

Digitization in the donations and disbursements space were already a key global trend for multilateral development organizations before COVID-19. Now, as part of their response to the pandemic, development organizations and NGOs are looking to digital funding tools as potential solutions for the challenges they face.

Crowdfunding: Social media is critical

COVID-19 has put governments, companies and the development sector under financial pressure. Many development organizations face funding gaps as a result of the economic downturn and shortfalls in traditional government contributions. One increasingly popular solution for development organizations and NGOs seeking to diversify funding and raise funds in crisis situations is crowdfunding from citizens: COVID-19 makes such strategies even more relevant.

Digital campaigns can appeal to citizens through social media and the ease of making donations using a variety of traditional and alternative payment methods. They have transformed the mechanics of donations by improving efficiency. Social media is a critical factor in crowdfunding success: for every order of magnitude increase in Facebook friends of 10, 100 or 1000, the probability of success increases by 9%, 20% or 40%.⁴ In a world of social media, attention is currency.

The World Health Organization (WHO) is leading the global effort in supporting countries to prevent, detect, and respond to the pandemic. Working with the UN Foundation, WHO rapidly established the COVID-19 Solidarity Response Fund. With a straightforward donation mechanism for citizens and companies, it raised nearly \$235 million to procure and distribute essential commodities, catalyze vaccine R&D and protect at-risk communities, such as children and refugees.

¹ <https://coronavirus.jhu.edu/map.html>

² <https://www.weforum.org/agenda/2020/09/an-economist-explains-what-covid-19-has-done-to-the-global-economy/>

³ <https://www.un.org/en/un-coronavirus-communications-team/funding-fight-against-covid-19-world%E2%80%99s-poorest-countries>

⁴ <https://nonprofitssource.com/online-giving-statistics/#Mobile>

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Digitization of both donations and disbursements was already a hugely important trend that has gathered pace in recent years. COVID-19 has accelerated its adoption.

Digital campaigns can appeal to citizens through social media and the ease of making donations using a variety of traditional and alternative payment methods.

As the pandemic reached its initial peak, the advocacy organization Global Citizen organized an online concert to encourage people to stay home and recognize the efforts of frontline workers. Global Citizen hosted an online broadcast called 'One World: Together at Home' curated by Lady Gaga, with A-list stars, interviews with health professionals, and touching footage of people coming together around the world to help one another. While not a telethon, the event encouraged support for the COVID-19 Solidarity Response Fund and raised \$55 million; Global Citizen also raised \$72 million for local relief efforts.

Donations should be digital, simple, safe and seamless

As development organizations seek to diversify and raise funds globally through crowdfunding and electronic channels, they need to consider a number of issues. Leading with a clear cause-based campaign message is critical to reaching citizens and encouraging them to give. Equally important is understanding how, when and where citizens decide to give: in recent years this has become increasingly digital.

Institutions need to consider citizens' mindsets when seeking to crowdfund, and make the experience simple, safe and seamless - it should be as easy as ordering an Uber or an item on Amazon. As organizations seek to establish long-term donation relationships with citizens, they must also be aware of e-commerce payment trends and consumer behaviors, including:

- Decrease in cash and check payments
- Decrease in larger amounts and increase in miniaturized payments
- Increase in demand for instantaneous payments
- Increase in cross-border payments
- Increase in bank transfers, cards, eWallets and other digital methods
- Increase in transparency, security and reporting demands

⁵ <https://nonprofitssource.com/online-giving-statistics/#Mobile>

⁶ <https://nonprofitssource.com/online-giving-statistics/#Mobile>

While every country has causes with specific relevance and citizens have a variety of donation preferences, more than 50% of donors worldwide prefer to give online with a credit or debit card.⁵ In the U.S., credit card donations are most common, although alternative payment methods, such as PayPal and QR codes, are increasing.

Donors' payment preferences worldwide⁶

- 54% Online with a credit or debit card
- 11% Direct mail
- 11% Cash donations
- 10% Bank or wire transfer
- 9% PayPal
- 4% Mobile app or wallet
- 1% Text message

Another means of donations is telethons and text-to-give schemes, where citizens text to donate via their mobile provider, which then passes on the funds to the fundraisers. For example, over \$43 million was raised by the Red Cross's Haiti earthquake relief text-to-give campaign.⁷ In other countries, bank transfers, checks or cash remain the most popular way for citizens to donate. Ultimately, institutions need to ensure they can receive consumer donations in a simple, safe and seamless way, by applying a digital strategy that aligns with consumer behaviors in each market.

Citizens who donate want to know how their money is spent. Development organizations and NGOs that seek donations from citizens must therefore measure the impact of funds raised and communicate it effectively. From donations to disbursements, organizations can demonstrate accountability and efficiency using new technology and digital solutions.

Mobile money best practice: Inspiring examples

In developing countries, there are a wide variety of financial ecosystems and market infrastructures; some lack mobile solutions or adequate regulation. However, there are also pockets of excellence across Africa, Asia and the Americas, where financial services and mobile money for the poor or most vulnerable populations offer valuable best practice guidance for humanitarian banking during COVID-19.⁸

Benefits of Mobile Money During The Pandemic

- Promotes cashless economies and 'no touch' digital payments
- Promotes social distancing
- Promotes collaboration between public and private sector
- Promotes efficiency and safety
- Promotes propensity to adopt through consumer behavior

In order to increase the spread of best practice, the World Food Programme (WFP) and GSMA, the industry association of over 750 mobile network operators, recently expanded their partnership to help the world's most vulnerable people. The GSMA Mobile for Humanitarian Innovation program, which has been funded by the UK Department for International Development since 2017, focuses on the use of mobile money to deliver cash-based transfers to save lives in global emergencies, including pandemics and natural disasters, such as COVID-19.

⁷ <https://nonprofitssource.com/online-giving-statistics/#Mobile>

⁸ <https://www.gsma.com/newsroom/press-release/gsma-and-world-food-programme-accelerate-the-use-of-mobile-financial-services-for-humanitarian-assistance/>

⁹ <https://www.gsma.com/newsroom/press-release/gsma-and-world-food-programme-accelerate-the-use-of-mobile-financial-services-for-humanitarian-assistance/>

"As humanitarian crises become more frequent, complex and protracted, the need to devise services that are scalable, replicable and efficient for humanitarian organizations has become crucial," said John Giusti, Chief Regulatory Officer at GSMA. "With over one billion mobile money accounts worldwide, the use of digital technology - specifically mobile money services - can provide the foundation for rapidly scaling cash transfers to safely and effectively deploy desperately-needed resources." Another key benefit is that mobile-based cash transfers can deliver essential support, while adhering to social distancing advice in compliance with COVID-19 guidelines.⁹

Colombia reaches three million using mobile wallets

As COVID-19 cases increased in Colombia, the government needed to disburse subsidies to vulnerable populations living under the poverty line rapidly in order to sustain their livelihoods, while also adhering to social distancing guidelines. The government wanted to collaborate with the private sector to digitize subsidies and make government-to-person (G2P) pandemic payments, while also promoting digital financial inclusion.

This public-private collaboration quickly mobilized a new digital transfer program called Ingreso Solidario. The ecosystem consisted of various key actors, including the Ministry of Finance, national planning, regulators, and financial and mobile services providers, such as banks, fintechs and telecom companies. Given the ongoing impact of COVID-19, the program has been extended until the end of the year.

Using mobile wallets, Ingreso Solidario reached three million vulnerable households, of which more than half were headed by women and almost one million were previously unbanked.

Why Colombia's Ingreso Solidario Worked

- Collaboration with private sector
- Leadership and clear communication
- Flexibility in delivery channels and outreach methods
- Consolidated registry
- Enabling regulatory framework

Africa's mobile money momentum accelerates

First launched in the 2000s, Safaricom's M-Pesa, which has expanded to several other countries, is one of the best known examples of cellphone-based banking in developing countries and studies have shown its considerable benefits in terms of economic growth. In Kenya, 72% of the population has a mobile money account, while in Uganda 43% do.¹⁰ The benefits of mobile banking ubiquity have been further highlighted by the experience of COVID-19.

Kenya's mobile banking volumes rose 16% from \$3.6 billion to \$4.18 billion in July, the biggest jump ever, while there were 158 million transactions, according to the Central Bank of Kenya.¹¹ In total, Kenya now has 62 million mobile money subscribers. The government sought to curb COVID-19 by encouraging the use of mobile money payments. Mobile money service providers removed charges on transactions below certain thresholds to support vulnerable populations, such as low-income consumers. Additionally, transaction fees for bill payment and transferring cash to bank accounts were eliminated to discourage the use of cash. Similar measures were implemented in Uganda.¹²

While other countries globally have failed to replicate the formula that led to success in Kenya given their different circumstances, the

pandemic has encouraged greater creativity among governments in the region. COVID-19 has accelerated the shift to mobile money by encouraging public and private collaboration. The following are some examples of advances made during the pandemic:

- Nigeria: The use of mobile money and 'no touch' cashless transactions grew by nearly 15% in March.¹³
- Rwanda: By late April, users were making three million more mobile-money transfers - a five-fold increase - compared to before the pandemic. The value of transfers between individuals rose six-fold to RWF40 billion (\$42 million).¹⁴
- Ethiopia: Despite protectionist policies and a cash-oriented society, mobile money looks set to grow because of COVID-19. A recent policy shift allows non-financial institutions to act as mobile-money providers, which will make mobile money more accessible. The government also recently introduced incentives for citizens to increase their use of digital payment methods.¹⁵

Philippines grows digital payments amid COVID-19 fears

Digital payments gained momentum in the Philippines as COVID-19 spread and made it difficult for consumers to pay at bank or store counters: citizens ditched cash to avoid physical contact. Registered users of the nation's largest provider of mobile money services, GCash, increased by 150% to 20 million after the initial peak of the pandemic; total payments made on the platform in May increased eight-fold from a year earlier. The current quarantine measures still require people and businesses to take steps to ensure social distancing which has boosted digital money.

As in other countries, the public and private sector have worked together to digitize

services and promote digital payments in the Philippines. With support from the government, taxis will soon be equipped with scan-to-pay systems so that users can pay by scanning QR codes displayed on fare meters with their smartphones.

The Philippine government is also stepping up efforts to promote digital currency. It has increased the number of government institutions that accept digital payment via EGov Pay, a digital payment platform for administrative services developed by government and public and private sector banks and launched last year. The government also plans to introduce a new National QR Code Standard by the end of the year. The hope is that country-wide use of mobile money will boost efficiency and safety by cutting lines at stores and government agencies.

In addition, the central bank has said that electronic payments or mobile money will allow low-income earners without bank accounts to access financial services further promoting financial inclusion of the most vulnerable.¹⁶

GSMA's Top Mobile Money Regulatory Responses to COVID-19

- Collaboration with private sector
- Leadership and clear communication
- Flexibility in delivery channels and outreach methods
- Consolidated registry
- Enabling regulatory framework

Conclusion

Digitization of both donations and disbursements was already a hugely important trend that has gathered pace in recent years. COVID-19 has accelerated its adoption.

In terms of donations, the immediacy of digital payments - especially combined with social media - has the power to galvanize and mobilize public opinion and convert it into significant donations that can have a major impact in developing countries. At the same time, digital payments are simple, safe and seamless, improve efficiency and security (for donors and development organizations and NGOs) while enhancing reporting and accountability.

For disbursements, the impact of digitization - and especially mobile money - can be even more dramatic. As government responses to COVID-19 have shown, mobile money can deliver emergency funds to vulnerable groups rapidly. Moreover, by avoiding the need to handle physical cash, mobile money increases security and reduces fraud while promoting social distancing with 'no touch' payments.

The swift response of many emerging market governments around the world to COVID-19 and the recognition of the value of mobile money is encouraging. The pandemic has acted as a catalyst for public and private sector collaboration and will spur governments to develop and refine regulatory frameworks for mobile money. While COVID-19 is a human tragedy that will have repercussions for years to come, the mobilization of fundraising support and increased reach of mobile money will have lasting positive consequences. ■

¹⁰ <https://www.vox.com/future-perfect/21420357/kenya-mobile-banking-unbanked-cellphone-money>

¹¹ Webinar: Public-private collaboration in COVID-19 emergency payments response: Lessons from Colombia <https://www.youtube.com/watch?v=d-vc3YsPBeQ&feature=youtu.be>

¹² <https://medium.com/@acclabs/mobile-money-and-covid-19-what-can-we-learn-from-east-africa-5df456ca907b>

¹³ <https://www.voanews.com/covid-19-pandemic/coronavirus-pandemic-fuels-mobile-money-transactions-nigeria>

¹⁴ <https://www.economist.com/middle-east-and-africa/2020/05/28/the-covid-19-crisis-is-boosting-mobile-money>

¹⁵ http://www.xinhuanet.com/english/2020-09/01/c_139334795.htm, <https://www.dw.com/en/ethiopians-are-dipping-into-digital-wallets/a-54917399>

¹⁶ <https://asia.nikkei.com/Business/Companies/Digital-payment-grows-in-Philippines-amid-COVID-19-fears>



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International bond markets recovered rapidly from the depths of the crisis in March, enabling many emerging market sovereigns to raise funds to fight the health and economic consequences of COVID-19.

Preparing for a Potential Emerging Markets Debt Crisis: A Response Toolkit

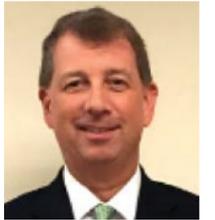
International bond markets recovered rapidly from the depths of the crisis in March, enabling many emerging market sovereigns to raise funds to fight the health and economic consequences of COVID-19. But sentiment could quickly change: both public and private capital need to be creative and constructive in supporting emerging market borrowers across the rating spectrum in the event that the crisis deepens.

Emerging market (EM) countries have been hit particularly hard by COVID-19 due to the structure of their economies, which are exposed to terms of trade shocks, given their vulnerable fiscal positions lacking financial buffers to absorb disruptions to growth or revenues. When the pandemic gained a foothold in advanced economies, it exposed the vulnerabilities of EM economies dependent on external trade and foreign currency inflows. The effect of COVID-19 in EM countries also prompted domestic lockdowns, putting further pressure on businesses and households, straining health services systems, and stretching the capacities of governments to respond and deploy adequate measures to address the immediate costs of the pandemic.

Financial markets around the world initially panicked, with spreads on EM debt ballooning from less than 300 basis points (bp) over Treasuries at the turn of the year to more than 700bp in early April;¹ for example, five-year credit default swaps on Latin American sovereigns followed this trajectory while EM corporate spreads moved even wider.²

Central banks and governments around the world - led by the U.S. Federal Reserve - responded by unleashing unprecedented liquidity injections and stimulus and support measures. With investors no longer under pressure to sell or repo, bond markets rapidly recovered, first in the developed economies closely followed by emerging markets. Combined with the partial recovery in oil and other commodity prices, sovereign yields across most of EM have now tightened to pre-COVID-19 levels: EM markets continue to experience net inflows.

The recovery in bond markets so far has brought welcome relief to some EM borrowers. While new bond issuance collapsed in March, it recovered rapidly to surpass 2019 levels in May, June and August; year-to-date issuance has reached \$575.4 billion, well ahead of 2019's \$497.9 billion for the comparable period.³ While most Sub-Saharan African borrowers are not yet able to access the market, Latin American sovereigns in particular have taken advantage of improved market



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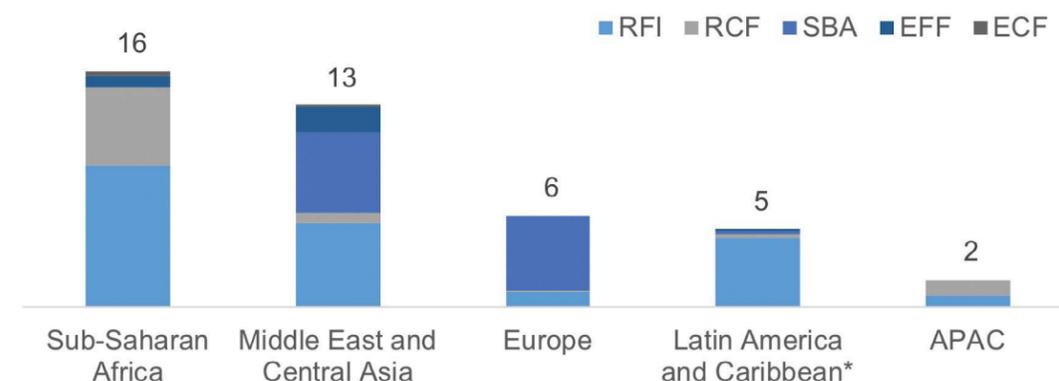
¹ Dealogic and Citi as of August 28, 2020
² Citi and Bloomberg as of August 28, 2020

conditions, with investment grade Panama the first to venture into the market in late March, followed by Mexico and Peru in April, Chile in May, and Uruguay in June. High yield sovereigns Paraguay and Guatemala came to market in April, followed by Brazil and Honduras in June and most recently the Dominican Republic in September. Issuers from other regions were also active, including Egypt, Ukraine, Ghana, Turkey, Bahrain, and Albania.

Market recovery was fast but concerns are mounting

The IMF disbursed record COVID-19 related emergency funding through its Rapid Financing Instrument (RFI) available to all its member countries. This was followed by Rapid Credit Financing (RCF) and Stand-By Agreements (SBA) to support the capacity of affected countries to implement appropriate response policies. These actions helped to boost market confidence.

IMF COVID-19 lending by region from March to September 2020, in \$ billion

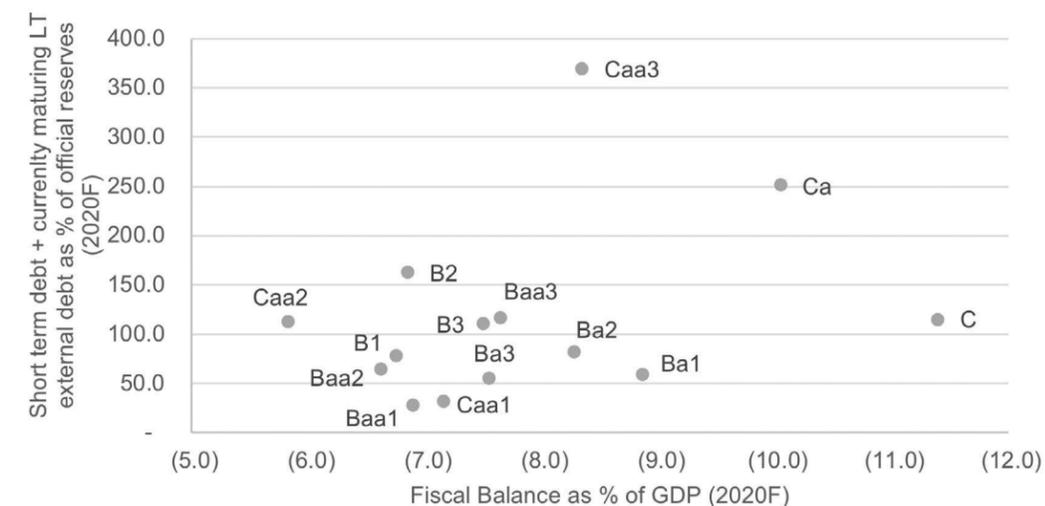


Note: *Excludes Flexible Credit Lines (FCL) to investment grade countries totaling \$51.9 billion
Source: IMF COVID-19 Lending Tracker

Initial worries about the investor appetite for sovereigns' large borrowing needs and the potential need for multilateral support have dissipated rapidly; over-subscriptions and upsized order books have once again become routine. As the EM market has sequentially opened to weaker credits, the list of countries at risk of being shut out of the market has grown shorter. Nevertheless, the recovery in EM spreads and the renewed ability of EM issuers to come to market has been uneven, and this favorable market environment does not negate changes to underlying fundamentals over the past six months that could still cause problems in the near future.

Chief among these is the steep rise in debt-to-GDP ratios across EM countries as economies contracted sharply and governments secured funding to tackle the pandemic. Global debt-to-GDP grew to a new record of 331% in Q1, up from 320% in Q4 2019, with EM debt increasing to over 230% of GDP in Q1 2020 (compared to 220% in 2019).⁴ While total EM FX debt was broadly stable at \$8.4 trillion in Q1, suggesting sovereigns and corporates could still roll over FX liabilities, risks have clearly increased. More critically, debt affordability metrics (particularly interest expense to government revenues) - which have tended to be more closely correlated with sovereign defaults historically - have deteriorated, reflecting the collapse in tax revenues.

Underlying credit fundamentals have weakened significantly over the course of 2020 (percentage average estimate for 2020)



Source: Moody's CreditView Fundamental Data & Metrics, accessed September 22, 2020

The concern is that economies might contract further if there are new waves of COVID-19, leading to renewed lockdowns and a further shock to market confidence. Even if global markets are awash with liquidity, investors could abandon EM debt if they believe that debt is becoming unsustainable. What began as a liquidity crisis could - if investor sentiment changes - become a solvency crisis. With around \$3.7 trillion of EM debt due before the end of 2020, and FX-denominated debt accounting for nearly 17% of the total, the scale of the potential problem is significant.⁵

Bringing multilaterals and investors together

Given the breathing space afforded by central bank liquidity injections and improving investor sentiment - as demonstrated by continuing new issuance, including from non-investment grade borrowers - it makes sense to proactively

develop a contingency plan that could support EM borrowers should markets begin to turn against them. Key to this process should be increased dialogue among multilateral development banks (MDBs), private banks and bondholders to develop solutions and tools to avert or mitigate a potential funding crisis and to safeguard the prospects for economic recovery in EM countries.

Such ideas have been mooted in the past, but have not come to fruition. One reason for this is that there is often a perception in official circles that helping private bondholders hurts the public sector. However, the bond market is not a zero-sum game: it is in the interest of both borrowers and investors to facilitate an orderly market and avoid bonds trading at distressed levels. Moreover, the unique circumstances of the COVID-19 crisis make the need for dialogue all the more acute. To make progress and to avoid worse-case scenarios, all parties will need to be flexible and creative.

³ Dealogic as of August 28, 2020

⁴ https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_July2020.pdf

⁵ https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_July2020.pdf

A solutions toolkit to head off a solvency crisis

While markets remain sanguine at present about the risk of an emerging markets solvency crisis, the potential for markets to shut rapidly in the event of a renewed shock is significant. How could central banks and MDBs respond to such a closure?

1. Use of central bank liquidity facilities:

Developed market central banks could provide cheap liquidity to a special purpose vehicle (SPV), which would allow EM debt investors to repo a combination of secondary and new issue bonds. This would avoid the need to liquidate bonds in the event of market stress. Investors would be subject to daily margin calls on the repo (a commercial bank administering the structure would take the investor counterparty risk). The central bank's exposure would be to the commercial bank and investors - only in extreme circumstances would they be exposed to the EM bonds. In order to improve the repo haircut, an MDB could provide a first loss to the SPV. This equity, added to the cheap funding, would be passed on to the EM country via the lower cost of the new bonds issued to the structure.

2. MDB envelope deployment into secondary market purchases:

Should an EM bond reach distressed prices (60% of face value or less), an MDB could purchase bonds in the secondary market (in coordination with the issuer) to help support prices. If the market returns, the bonds could be re-sold in the secondary market. If it does not, the money invested could be counted against other disbursements that the MDB has made to the country. Retiring debt at a discount would imply less funding for other uses, but would help to capture the discount on behalf of the issuer (and represent a crystallized loss to the private sector), improving the efficiency of the market.

3. More efficient use of MDB guarantees:

Partial Risk Guarantees (PRGs) are inefficient in terms of the pricing benefits they confer. An alternative solution would be for MDBs to charge private sector market prices for guarantees and enable market transactions - such as an SPV that allows tranching and new debt to flow to EM issuers, or supply chain finance - to be structured around them. The cost of the structures would not be concessionary (as with a PRG), but it would attract private sector capital to EM debt at times of stress. Alternatively, MDBs could distribute PRG loans and bonds into the market through a standardized note issuance platform (like a Medium Term Notes program) that is able to accommodate and maximize investor appetite with regard to currency, tenor, fixed/floating rate and proportion of PRG. This approach would help recycle PRG bonds and loans for a multiplier effect, unlock investor appetite and scale MDB capacity.

4. Effective standstill for near-term distressed sovereign debt:

Distressed sovereigns should have at their disposal a market-friendly mechanism that postpones principal and interest payments in a way that is orderly, avoids default and is systemically scalable. Instead of making cash interest and amortization payments to existing investors, the sovereign would issue single series, zero-coupon interest promissory notes and principal promissory notes to holders of record on the respective interest payment date or maturity date. This would allow them to re-direct current cash away from private sector creditors and toward crisis response until market normalcy returns and classic reprofiling and restructuring (Sovereign Liability Management) techniques can be implemented. Avoiding sovereign disorderly defaults will benefit all issuers and investors by reducing the risk of panic redemptions and severe EM contagion effects.

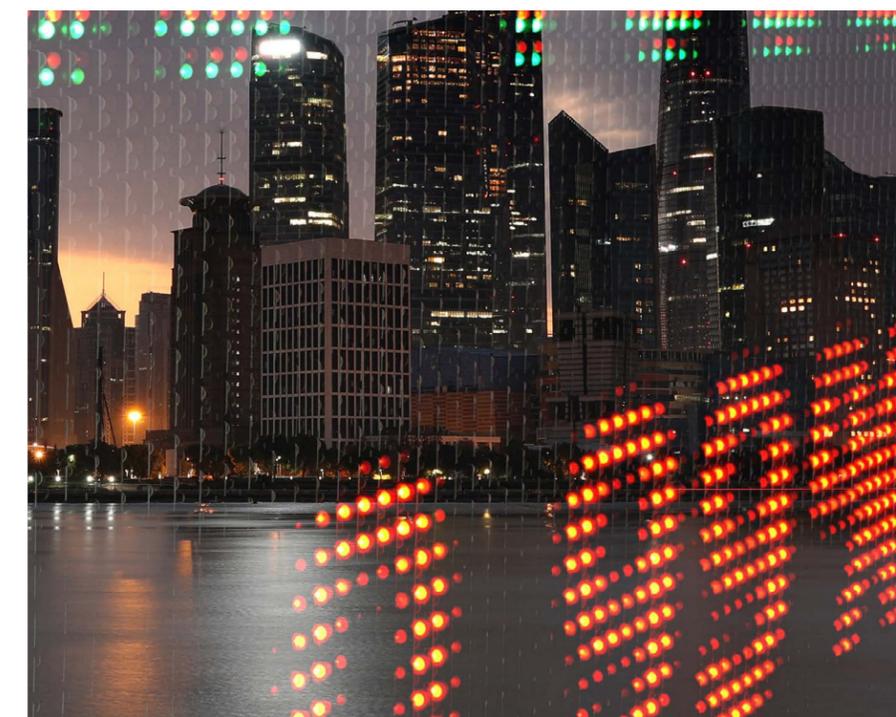
5. Blended fund with MDB first loss layer: EM sovereigns, MDBs and private institutional investors, with input from rating agencies, could jointly create a Blended Fund with risk-absorbing tranches that aggregates financing requests from EM countries, leverages grant monies and lifts complicated and cumbersome project-by-project blending to the Fund level. The Fund would be guaranteed at a defined loss level by grant funding from MDBs or other partners to achieve investment grade-rated issuance, thereby attracting private institutional investor capital at appropriate risk-return levels.

An immediate call to action

The suggestions above and other innovative ideas should be discussed in a formal forum that brings together the official and private sectors to create a crisis response framework and gives momentum to proposed solutions. There is no time to lose, given the still looming uncertainty and the potential risk of a new sudden stop to economic activity.

Countries should use this relatively benign market window to design and implement an arsenal of solutions that are ready to be deployed when a crisis hits, rather than waiting and then finding themselves in the difficult position of having to create solutions in an ad hoc and sub-optimal way while in the middle of the battle. If in the end no immediate crisis emerges, countries will be left with a toolkit that will be accretive to resource mobilization and market stability. One way or another, these efforts will have contributed to economic development and sound debt management policy. ■

Countries should use this relatively benign market window to design and implement an arsenal of solutions that are ready to be deployed when a crisis hits, rather than waiting and then finding themselves in the difficult position of having to create solutions in an ad hoc and sub-optimal way while in the middle of the battle.



The financial industry in particular has a special responsibility to act on issues of racial and gender equity to create a fair and inclusive society; it plays a pivotal role in the economy and is uniquely capable of helping to close the gaps that exist.

Using the Banking Sector to Bring Opportunity to All

During 2020, the world has been challenged by a global pandemic, the likes of which we have not seen for over a century. While all nations have suffered greatly from the virus, the U.S. has been particularly hard hit, with some of the fastest and largest increases in daily transmissions in the world. COVID-19 has disproportionality affected Blacks and People of Color, most likely due to more limited access to quality and affordable healthcare. Exacerbating the ongoing racial disparities of this health crisis are underlying inequalities in education, access to financial products and wealth generation and the slow pace of criminal justice reform. Calls to address these inequalities reached a crescendo in July following the death of George Floyd, an unarmed Black man, whose death at the hands of police was captured on video and ignited global protests.



Harold Butler
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Across multiple sectors, corporates have responded boldly by looking inward at their own business and corporate social responsibility practices. Importantly, they have sought ways to create greater opportunities for People of Color and women. The financial industry in particular has a special responsibility to act on issues of racial and gender equity to create a fair and inclusive society; it plays a pivotal role in the economy and is uniquely capable of helping to close the gaps that exist. According to the recently published Citi GPS report, *Closing the Racial Inequality Gaps*, if the U.S. had closed key racial gaps for Black Americans in wages, housing, education and investment 20 years ago, up to \$16 trillion might have been added to the U.S. economy. If these gaps are closed today, up to \$5 trillion could be added to U.S. GDP over the next five years. These figures vividly illustrate the need for increased wealth generation within Black and minority communities

In Congress and within other areas of the U.S. Federal Government, there have been growing calls for large financial institutions to provide greater support to minority communities by helping Black and women-owned community banks. The need is urgent: the number of these institutions continue to shrink. The Federal Deposit Insurance Corporation, a U.S. regulator, has noted that the total number of banks it insures has declined by 45% since 2001, while the number of Black-owned banks has declined by 56% over the same time. COVID-19 threatens to exacerbate this trend. Only by surviving can minority depository institutions (MDIs) continue to address the needs of their underserved communities and help speed up the U.S. economic recovery.

Large financial institutions can aid minority communities by supporting MDIs in their efforts to gain work for federal, state, and local governments, uncover new commercial opportunities to grow revenue, strengthen their capital positions and improve efficiency.

The Financial Agent Mentor-Protégé Program

Working with government at federal, state and local levels can provide a dependable long-term source of revenue. But for Black- and women-owned community banks, such opportunities are hard to access. In 2018, the U.S. Department of the Treasury decided to address this challenge.

The Treasury's Bureau of the Fiscal Service awards its Financial Agent designation to commercial financial institutions that support key government lines of citizen- and government-facing business. The Bureau created a Financial Agent Mentor-Protégé Program to pair Financial Agents with minority- and women-owned banks so that they can potentially receive this designation and participate in the Financial Agent selection process. The process enables commercial banks to bid on new work; it could therefore open up a valuable long-term source of revenue that would otherwise be unavailable.

One of the first banks to benefit from the Mentor-Protégé Program is Industrial Bank, a large Black-owned and operated commercial bank. Working with Citi (which helped the U.S. Department of the Treasury to design the program), Industrial became the first Black-owned bank to serve as a federal subcontractor. Industrial Bank now supports Citi's management of the Bureau's OTCnet application, which processes \$100 billion of deposits annually, through the critical, customer-facing task of Agency Adoption. In the third quarter of 2020, Industrial Bank also began support for electronic check processing implementation, including onboarding.

Seven additional Protégé banks - Bank of Cherokee County (Talequah, OK), Citizens Trust Bank (Atlanta, GA), M&F Bank (Durham, NC), OneUnited Bank (Boston, MA), Optus Bank (Columbia, SC), United Bank of Philadelphia (Philadelphia, PA) and Unity National Bank (Houston, TX) - are now working with Citi to deepen their understanding of how to do business with the Federal Government: some or all of these banks may work with Citi on future federal business. These banks are also actively engaging with Citi to explore how working together can add value and facilitate new potential opportunities with the Bureau of Fiscal Service, as well as U.S. state and local entities.

Gaining access to opportunities is not enough, however. Large banks, and especially those designated as Financial Agents, also need to recognize that they may need to provide accommodations such as back office support to enable banks owned or controlled by socially or economically-disadvantaged groups to gain access to federal opportunities.

Opening up new business opportunities

In order to grow sustainably, a key goal for community banks is to gain access to new commercial business opportunities, including loan participation and credit assignments, which generate critical fee and interest income. Large financial institutions have a responsibility to help MDIs to broaden their access to both borrowers and lenders while ensuring that such initiatives align with their business objectives and meet the needs of the communities they serve. Recognizing how important fee and interest income are for MDIs, and in addition to creating loan participation opportunities, Citi is working on new ways to increase access to both borrowers and lenders, which is informed by our partnerships with MDIs and the communities they serve.

Opportunities can also emerge as a result of referrals of suitable business opportunities to Protégé banks. For instance, a Hispanic-owned company that approached Citi for a short-term loan was not a suitable lending candidate for Citi given its size. However, its strong balance sheet and portfolio of underlying assets made it a great opportunity for a Protégé bank, which subsequently syndicated the loan to other minority banks, increasing the bank's assets and generating additional revenue.

Scale and effective balance sheet utilization are critical

Business success is not just about gaining access to opportunities. Community banks also need a wide range of support to help them transform their businesses. Most obviously, minority-owned and women-owned banks need help to grow their corporate and retail banking activities. Scale is critical in banking and with the exception of one institution, no community banks have assets of more than \$1 billion, which is widely seen as a benchmark for the ability to operate efficiently. Scale is essential to ensure sufficient resources for the technology, compliance and other investments necessary to remain competitive, especially in a low interest rate environment.

A number of Protégé Program banks (along with other MDIs) are working with Citi to determine suitable forms of equity to improve their Tier 1 and/or Tier 2 capital, which would increase their capitalization and enhance their ability to grow and achieve scale.

Growing banks need to ensure that they allocate their balance sheets efficiently in order to optimize opportunities. Community banks were crucial for channeling government incentives such as Paycheck Protection Program (PPP) loans to small businesses to enable them to keep their workers on payroll during the onset of the COVID-19 crisis. However, these PPP loans consumed a sizeable part of some MDIs' balance sheets and created considerable exposure. Protégé banks (and some additional minority banks) have reduced their exposure by selling the loans to Citi, freeing up their balance sheet for additional lending activity.

Strengthening banks' capabilities

As well as greater opportunities, more capital, and stronger balance sheets, community banks need access to know-how and new technology to strengthen their capabilities so they can grow and provide greater support to the communities they serve.

CEOs of Protégé Program banks have opportunities to meet with Citi seniors and discuss issues of their choice, such as bank strategy and stakeholder engagement. Protégé banks are also able to access information about their chosen topics and transfer knowledge, expertise, learning and skills. Over the past year, Protégé Program banks have attended comprehensive Citi training sessions in which leaders from Treasury & Trade Solutions Innovation, Public Sector Banking, Consumer Banking, Risk and Compliance, Inclusive Finance and Global Public Affairs shared valuable insights. Each of the Protégé Program banks have held cross-collaborative meetings with Citi to help them develop their skills - both to improve their ability to bid on federal contracts and also to increase non-interest revenue.

Protégé Program banks also now have access to free services via a Technical Assistance Program, through a partnership between Citi and Deloitte that leverages Deloitte's rich consulting expertise and tools to help banks better plan for future growth.

Technology is critical to increased efficiency (and therefore profitability), improved visibility and control (and therefore enhanced risk management) and the ability to better serve (and therefore retain and attract) clients. However, developing platforms for mortgages, credit cards and other consumer and business products that would enable minority banks to diversify is costly and time consuming.

To accelerate access to these opportunities, large financial institutions should make technology available via white labeling so that community banks can offer their clients the functionality they need.

Talent acquisition and development is also a key need for MDIs. Prep for Prep, a New York based leadership development program, offers promising young students of color access to leading schools and the opportunity to be recruited by top tier corporate firms and financial institutions. As a result of a partnership between Citi and Prep for Prep, Protégé Program banks can engage with these students, providing opportunities for both, and helping to build stronger MDIs for the future.

Making a difference in communities across the U.S.

The Financial Agent Mentor-Protégé Program with the U.S. Department of the Treasury began with a straightforward ambition to bring federal contract opportunities to minority- and women-owned banks. However, community banks also need a broader range of capital, opportunities to grow and diversify their business, access to technology, and knowledge transfer in specific key areas. Large financial institutions have a responsibility to help MDIs achieve these goals.

The Financial Agent Mentor-Protégé Program, which has evolved significantly since its launch, has delivered impressive results. Doyle Mitchell Jr., President and CEO of Industrial Bank, the first bank to go through the Financial Agent Mentor-Protégé Program - and the only one to win a federal contract to date - says the partnership initiative has opened doors for the bank that would otherwise be closed. Most importantly, it has enabled the bank to keep the doors open for its community.

According to Laurie Vignaud, President and CEO of Unity National Bank, the program has transformed its business, enabling it to hire people and attract new customers. Yet despite these efforts, an existential threat hangs over many minority-owned banks. Speaking to American Banker, Vignaud explained: "Unless we look at how we leverage our relationships, position ourselves for growth and engage with the community, we could be a nonexistent institution in a few years."¹

Large financial institutions still need to do more to help to empower minority institutions and their communities, promote racial and gender equity and help to create a fair and inclusive society. Their efforts could play an important part in helping these essential institutions to equip themselves for success in the coming years. ■

¹<https://www.americanbanker.com/news/how-citi-is-helping-a-minority-owned-bank-get-back-on-its-feet>

Transforming Debt: Re-Focusing in the COVID-19 Era

This article looks at how multilateral development banks are helping borrowers, many of which have massive financing needs in the wake of the COVID-19 pandemic, to better insulate themselves from global events and systemic shocks by modifying the currency-denomination of their existing loans.

The IMF's World Economic Outlook Update, published in June 2020, predicts that the global economy will shrink by 4.9% in 2020 - 1.9 percentage points more than estimated in its April 2020 forecast. Emerging market and developing economies will contract by 3.0% this year - their first contractions as a group for at least 60 years. Considerable uncertainty remains about the course of the pandemic and the pace of any economic recovery.

The Secretary-General of the United Nations, António Guterres, believes the "unparalleled economic shock" of COVID-19 could put development gains at risk and notes that rebuilding to pre-crisis levels of employment and output may take years. The international development community anticipates that the severe and diverse impacts of the pandemic will exacerbate the challenge of achieving the targets set out in the UN Sustainable Development Goals.

The impact of the pandemic has not been uniform; some countries have been less affected or have coped better. Economically, countries that rely on sectors such as tourism, commodity exports and global trade have been hardest hit. Nevertheless, all emerging economies have faced challenges in addressing the health crisis against a backdrop of collapsing exports, dwindling remittances and tightening international credit conditions that require the implementation of austerity measures.

Despite the immediate challenges, many emerging economies have had the fortitude and foresight to de-risk their USD debt and assess their strategies during the crisis. As exchange rates spiked, public credit offices sought ways to limit their exposures and better protect themselves by fixing rates in dollars. As Claudia Franco, Head of Treasury Client Solutions for the Inter-American Development Bank, notes, borrowers had to go back to the drawing board; as well as de-risking, many countries have had to supplement their debt management plans and measures.



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The impact of the pandemic has not been uniform; some countries have been less affected or have coped better.

What have we learned about de-risking and currency composition during the pandemic?

1. Many emerging markets borrowers need to prioritize liquidity, funding and addressing the health and human aspects of the pandemic.
2. However, market volatility is expected to continue. Therefore, de-risking - which is a proven strategy with significant benefits - should also be a priority, focusing on a range of simple strategies.
3. During the initial stages of the COVID-19 crisis, most emerging market currencies devalued against USD, raising borrowers' costs. Hedging can protect against rising interest rates and further currency devaluation.
4. Debt to GDP ratios tend to increase at an accelerated rate when sovereigns with a high share of foreign currency debt face currency depreciation.
5. No borrower can be completely protected from systemic shocks and it is difficult to predict when the next one will come. Therefore, it makes sense to hedge risks while it is possible.

What do we see happening in the market?

- Interest rates, especially USD, are now at historic lows as central banks have been swift to loosen monetary policy during the COVID-19 pandemic.
- Emerging market currencies have devalued 10%-20% since the onset of the crisis.
- While borrowing in hard currency is viable when exchange rates are constant, it can be problematic during times of volatility. As the dollar's value increases, so do debt servicing costs, which, in turn, can worsen a country's finances and lead to a deteriorating credit rating, further raising borrowing costs.
- In local currency debt markets that lack sufficient liquidity, a conversion to local currency is a viable strategy as it allows the borrower to hedge a portion of its debt.

Emerging Market Currencies Devaluation

Major EM Currencies Devaluation at the Onset of Global COVID-19 Pandemic



USD Rates

5Y, 10Y, and 30Y USD Swap Rate Historical Dynamics (2000 – Present)



What are the driving forces behind the loan conversions?

Loan portfolios carry a number of risks including interest rate and refinancing risk. However, borrowers cite foreign exchange risk as the single most significant risk.

Dian Black, Principal Director Debt Management and Acting Deputy Financial Secretary in the Government of Jamaica's Ministry of Finance, says that de-risking transactions are critical to the country's debt management strategy. With foreign currency debt representing approximately 61% of its portfolio and a volatile foreign exchange rate, the government began to implement a de-risking strategy two years ago. Black intends to continue with this strategy, which has yielded significant savings.

In Costa Rica, a middle income country that has enjoyed steady economic growth over the past 25 years, one state-owned enterprise, Instituto Costarricense de Electricidad (ICE) borrowed in foreign currency to fund electricity generation projects during an aggressive period of development. The large-scale projects required liquidity greater than the local market could provide, prompting ICE to access the international capital markets in USD, as well as lending from bilateral and multilateral

banks. Borrowing in the international markets, especially from bilateral or multilateral development banks, was also cheaper than from local commercial banks.

Now, ICE has developed a strategy to reduce foreign currency exposure risk and begun to hedge using financial derivatives directly or indirectly - by executing a conversion clause in loan contracts from its multilateral development bank lender that allows a portion of foreign currency debt to be converted to local currency. These efforts are the beginning of a more global strategy that aims to reduce debt payment outlays attributable to the depreciation of the local currency and decrease volatility of the income and expenses statement.

In an increasingly challenging and uncertain global economic environment, prudent and proactive sovereign debt risk management remains essential.

Herman Kamil, Head of Sovereign Debt Management in the Ministry of Economy and Finance of Uruguay, shared that a cornerstone of Uruguay's debt management strategy is to increase the share of local currency in its sovereign debt portfolio, thus mitigating fiscal exposure to currency volatility and underpinning the country's credit quality.

Kamil highlighted that one way is to accomplish this is by increasing its funding in local currency in both domestic and global markets, with a particular focus on enhancing liquidity and diversifying its investor base for their internationally-issued peso bonds. Having access to local currency funding at competitive rates and from a wide array of investors offers an important source of financing flexibility and helps mitigate the impact of sudden movements in the exchange rate on debt ratios.

Uruguay also sees strategic value in de-risking its sovereign debt portfolio by continuing to execute currency conversion clauses on outstanding dollar loans into local currency with multilateral development banks. Given that multilaterals, in turn, hedge their currency exposure through USD-pesos swaps with market dealers, these transactions help market development by deepening liquidity across the local currency yield curve and benefiting price discovery.

Another borrower, the Ministry of Finance of one of the largest economies in Southeast Asia, has developed a strategy to diversify foreign currency borrowing in its debt portfolio by adding to USD a mix of EUR and JPY over the medium term. This diversification strategy was executed by re-denominating of a portion of their USD supranational debt to JPY and EUR, whereby the supranational then executed the JPY and EUR hedging swaps in the market. The Ministry of Finance has reduced the expected volatility of their hard-currency debt when measured in local currency, while also reducing the interest rate. The Ministry is now analyzing the benefits of de-dollarization to its local currency.

In an uncertain global environment, the de-risking of debt has ensured certainty of short, medium and long-term flows. It has also resulted in a more stable balance sheet that is progressively less exposed to exchange rate variations. These changes have been welcomed by the rating agencies.

What are the best examples of de-risking transactions that are deepening the market?

The current systemic crisis has proven that de-risking emerging and especially frontier market debt should be a strategic priority.

Both the Central Governments of Jamaica, Costa Rica and Uruguay have been leaders in Latin American frontier markets, adapting IDB de-risking strategies for their loan portfolios and aligning with credit agencies' guidelines regarding FX composition of public debt.

In the largest frontier currency inflation linked swap in the history of Latin America, Uruguay successfully converted \$150 million of Inter-American Development Bank debt to Uruguayan peso inflation index ("UI") in June, 2020.

In the longest tenor frontier markets currency swap in the Caribbean region, Jamaica converted a portion of 20-year Inter-American Development Bank USD debt to Jamaican dollar in June, 2020.

These trades resulted from IDB's focused efforts to help their sovereign borrowers to de-risk and improve their debt profile, while also achieving one of its strategic priorities. The carefully executed conversions over the last few years not only helped Jamaica and Uruguay de-risk their hard-currency debt, but also to do so at competitive local currency interest rates and for a long tenor, often expanding or deepening liquidity at long-ends of the local curve.

It is important to note that the frontier currency conversions almost exclusively occur by re-denominating the loan to local currency, while keeping USD as the settlement currency. From an economic and accounting standpoint, this results in local currency debt as the borrower owes less USD in the event that the local currency devalues - but also provides for an easy execution of the conversion and ability to execute larger sizes.¹

¹Ability to settle the converted debt in USD leads to the multilateral development bank lender's ability to hedge the conversion in the international markets, benefitting from potentially wider range of dealers and investors in local currency.

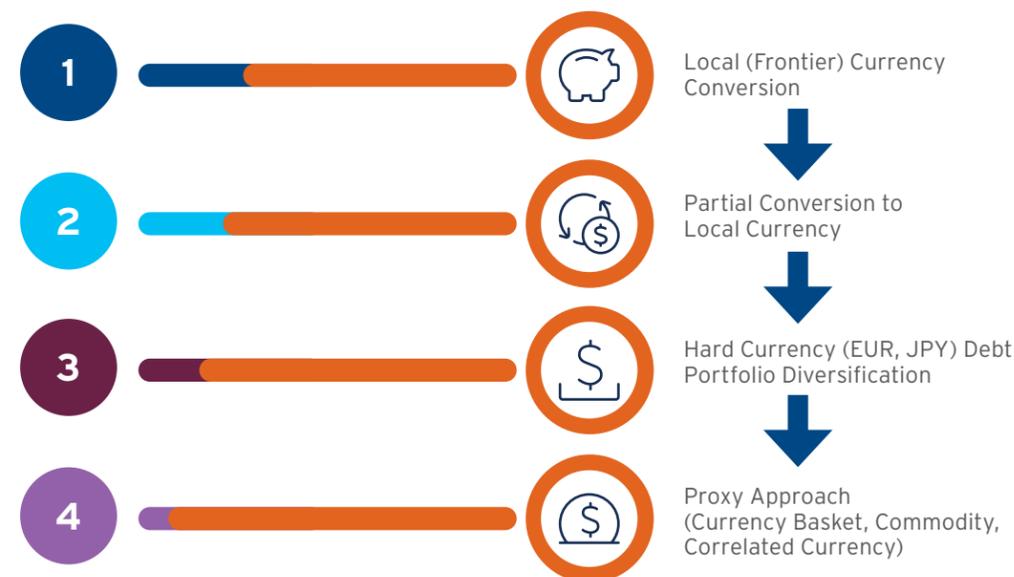
Conclusion

Black swan events remind us of the importance of being prepared. However, in a crisis such as COVID-19, perfection is the enemy of effectiveness. Those countries that actively managed their debt composition - to any extent - benefited from greater protection and more effective risk management.

While challenges exist, such as the limited number of international and domestic investors focused on emerging market currencies, multilateral development banks continue to respond to borrowers' needs by partnering with international banks to facilitate loan conversions that de-risk emerging market debt and deepen market in local currencies.

The frontier markets continue to present the biggest de-risking challenge, given the illiquidity of their capital and derivatives markets. Partial debt conversions, hard currency diversification (to EUR, JPY or CHF) as well as a proxy portfolio or basket of currencies are all strategies that have gained popularity in recent times. While such strategies do not attain the full hedge to local currency, they statistically reduce the volatility of a single hard-currency debt portfolio and may be executed with *optionality* that limits the downside currency scenarios. We intend to explore such option-based de-risking strategies during our next proprietary roundtable on this exciting and increasingly important topic of modern finance. ■

Cascade Approach



¹Ability to settle the converted debt in USD leads to the multilateral development bank lender's ability to hedge the conversion in the international markets, benefitting from potentially wider range of dealers and investors in local currency.



Leveraging the New Gold Rush: How to Extract Greater Value from Gold

Gold has proved a defensive and stabilizing influence on portfolios during COVID-19, capping a decade during which it has enjoyed a renaissance as a strategic asset for the official sector, propelled by growing central bank demand. By utilizing new financial tools, the official sector can gain even greater benefits from its holdings.

Gold has become a key strategic asset during the COVID-19 pandemic. It has long been viewed as a safe haven, acting as a store of value for investors when other investments are volatile. It can also be used as a hedge against falls in stocks, currencies and bonds while providing diversification and, potentially, higher risk-adjusted returns. Given today's uncertain macro climate, gold's value proposition is widely recognized. The spot gold price has broken through the \$2000/oz barrier reaching all-time highs, overtaking its previous record of \$1,920 achieved in September 2011.

Gold market bull cycles tend to endure for years, not quarters, and with the backdrop of unprecedented central bank stimulus, the gold price can be expected to remain higher for longer. In the post-Bretton Woods/Nixon currency shock era, three gold market bull runs stand-out: 1971-1980; 2001-2007; and 2009-2012, during which real and nominal gold market annual returns averaged 17% and 21% respectively. Current gold markets appear to be in the middle of a similar secular bull cycle; a new record USD gold price may be within reach.¹

Central bank buying slows but trend persists

In recent years, central banks (CBs) have become net buyers of gold. This contrasts with 2008/2009 and the preceding decade where they were net sellers, with an average sales volume of 400 tonnes per year, CBs represented an important part of the global gold supply, now they are an important driver on the physical demand side of the equation. More recently this trend has slowed with some CBs even selling gold holdings.

Crucially, despite the slowdown in purchases, the clear trend in recent years remains one of net buying. Global CB gold holdings of around 35,000t (an impressive 10 times the size of gold ETF holdings and a decade worth of gold production) are still expanding, with gross purchases exceeding bullion sales.²



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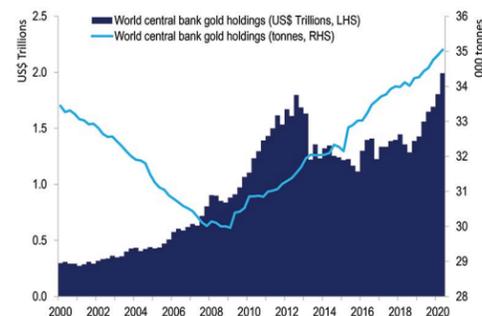
¹Citi Research: Global Commodities Quarterly, 4Q 2020 Outlook.

²Citi Research: Going for GOLD, <https://www.citivelocity.com/tr/eppublic/1ty33>

Gold has become a key strategic asset during the COVID-19 pandemic. It has long been viewed as a safe haven, acting as a store of value for investors when other investments are volatile.

Adding gold to a portfolio has a diversification effect. Its low correlation with other assets makes it very effective in enhancing portfolio diversification and therefore reducing risk and volatility.

Central bank gold holdings* (2000-2020)



Source: IMF, LBMA, Citi Research, *allocated reserves

Why reserve managers hold gold

What is driving CBs' gold purchases in recent years? There are multiple reasons for reserve managers to invest in gold:

- **Gold has no credit risk** as it is nobody's liability, and its value cannot be controlled by any institutions or governments.³
- **Gold is negatively correlated against the US dollar** making it an effective hedge against dollar-denominated assets. It has posted fresh nominal records across all G10 FX crosses and major EM pairs this year, most recently in Q3, benefiting from USD weakness. This boosts financial demand for gold as a currency hedge or portfolio overlay.⁴
- **Gold is very liquid**, especially in stress situations and its trading volumes and market size are higher than several bond and stock markets.⁵
- **The opportunity cost of holding gold is minimal in the current low or negative interest rate environment.** A large proportion of central banks are limited to short investment tenors. Given the short-dated nature of their bond holdings, the yield of the bonds they hold is typically low or negative. While gold is non-interest bearing it is highly liquid, making it a potentially attractive alternative.⁶
- **Adding gold to a portfolio has a diversification effect.** Its low correlation with other assets makes it very effective in enhancing portfolio diversification and therefore reducing risk and volatility.⁷
- **Gold is a long-term store of value** and generally has a role of reinforcing trust and improving stability in times of uncertainty.⁸

³ LBMA Alchemist 57: Paul Mercier, The Eternal Question of Gold in the Official Sector

⁴ Citi Research: Going for GOLD and why the current bull cycle still has legs <https://www.citivelocity.com/t/r/eppublic/ty33>

⁵ WGC: A Central Banker's Guide to Gold as a Reserve Asset

⁶ WGC: A Central Banker's Guide to Gold as a Reserve Asset

⁷ WGC: A Central Banker's Guide to Gold as a Reserve Asset

⁸ LBMA Alchemist 97: New Golden Age, Building up Gold Reserves

Market value of negative yielding debt (global; \$m)



Source: Bloomberg, Citi Research

How gold reserves are managed

When managing portfolios, the key objectives of reserve managers are safety, liquidity and return on investment. For most central banks, gold is held for safety and liquidity; returns are less of a priority.⁹ As in previous crises, gold has demonstrated its defensive and stabilizing properties from a portfolio perspective during COVID-19: in most markets, gold outperformed the respective domestic stock market. Positive returns tend to encourage the further building of international reserves.

Gold as a reserve asset combines the characteristics of a currency with some features of a commodity. While the official benchmark price for gold is the immediate (spot) delivery of the metal in London, there are many alternative ways of owning and taking delivery of the yellow metal in different types of accounts, various locations and with different sizes and purities of bars. Bars can also be acquired via listed futures contracts on the CME exchange in New York, again with different specifications compared to metal traded in other locations.

⁹ LBMA Alchemist 97, New Golden Age, Building up Gold Reserves

¹⁰ LBMA The Guide, An Introduction to the Global Precious Metals OTC Markets

Gold futures prices across G10 FX (December 1, 2018 = 100)



Source: Bloomberg, Citi Research

All these factors have an impact on the relative value of specific gold holdings versus the London price benchmark and can have implications in terms of safety, liquidity and return. Therefore, reserve managers should consider diversification of how they hold their gold in order to achieve their objectives.

Account types: A question of credit exposure

Investors can choose between unallocated or allocated custody in terms of account types. In an unallocated account, the account holder has a claim against the custodian over a pool of gold as opposed to owning specific bars. Therefore, the metal has some credit risk as it sits on the balance sheet of the provider.

An allocated account is backed by specific bars held in segregated custody in the name of the account holder and therefore does not carry any credit exposures. Typically, transactions between allocated accounts result in physical movements of bars, unless both buyer and seller hold their metal with the same custodian and the movement can be done simply by book entry transfer.¹⁰

While trading unallocated gold is more convenient from an operational point of view, when holding gold with a long-term investment horizon and in order to minimize their credit risk, central banks typically hold their balances in an allocated account.

The importance of storing gold in a liquid market location has faded in recent years as several central banks have decided to rebalance the geographical distribution of their holdings and repatriate large quantities of gold to reduce concentration and exposure to geopolitical risks.

Storage: The impact on safety and liquidity

Certain vaults or countries are considered safer than others and their distance to the main trading centers can affect the ability to bring the bars to a liquid market. Once the gold is in a liquid location, an active market for location swaps enables investors to swap between locations, for example between London, Zurich and New York.

In London, the Bank of England (BoE) vault is a preferred location for reserves managers, as it combines access to the liquidity of the London market with the security guaranteed by the allocated nature of the accounts. Gold held in the BoE vaults can be quickly traded or swapped without incurring credit exposures typically associated with the wider unallocated market. This is possible because many commercial and bullion banks also have allocated accounts at the BoE so bars can be transferred across accounts simply by book entry, without the need to be physically moved.¹¹

The importance of storing gold in a liquid market location has faded in recent years as several central banks have decided to rebalance the geographical distribution of their holdings and repatriate large quantities of gold to reduce concentration and exposure to geopolitical risks. Additionally, to improve transparency many central banks now publish detailed information on the origin, quantities and location of their reserves.

Why quality and specification matter

The rebalancing and new transparency measures described above have, in some cases, been combined with upgrade programs to convert old gold bars or coins to the London Good Delivery (LGD) standard. The size and purity of bars is important as it can impact liquidity and valuation; old bars need refining and/or recasting in order to be sold or swapped and therefore trade at a discount to the benchmark.

The price of Gold futures at the end of the first quarter for June delivery traded on the CME in New York climbed to a peak premium of \$67.57 an ounce over spot prices in London highlighting the importance of location and quality of gold holdings on liquidity and pricing, especially during disruptive events such as COVID-19.

London and New York are both very liquid markets but differ in terms of location, quality and timing of metal deliveries. The Loco London price represents the value of standard 400 ounce bars for immediate delivery in a vault in London; the price of a futures contract on CME refers to the delivery of Comex-compliant 100 ounce bars at a future time stated in the contract and in one of the CME depository vaults in New York.

Case Study: Gold Upgrade Solutions

Under a typical gold upgrade transaction, a central bank would deliver old bars (non-LGD) to a refiner which would refine and recast the metal into new LGD bars in exchange for a refining fee. Under such a structure, the central bank does not earn any yield when the gold is being refined, and is subject to the operational risks and limited processing speed of the refinery, which could lead to significant processing time for large orders.

In order to mitigate these aspects Citi can offer a location and quality swap, where the central bank delivers gold to Citi, which simultaneously provides LGD bars (in London, for example), on the same value date and without requiring the payment of any refining fees. In order to cover the costs of the upgrade, the central bank would agree to place the metal in deposit with Citi for a pre-agreed duration and at a rate that would embed that cost as well as a positive yield. Such a solution would remove any exposure to the refinery, would reduce processing times and generate a saving on storage costs for the duration of the deposit as well as generating instantaneous yield.

Citi can also facilitate upgrade programs designed to bring the quality of bars into line with LGD requirements via quality swaps.

Gold traders access exchange liquidity to manage their risks in the OTC spot and forward markets, but rarely consider the different physical specifications of these instruments. Under normal market conditions this is inconsequential. The price differential between the two, expressed by the EFP (Exchange For Physical), is relatively stable and reflects the costs of sourcing the CME bars, insuring, transporting, financing and storing them in New York; the futures contract is usually slightly more expensive than the spot price. However, when the normal market dynamic was disrupted by COVID-19 – gold refiners closed their factories and airlines suspended flights to New York – the inability to source 100 ounce bars and move them to a CME vault caused an imbalance; the price differential widened to a multiple of its previous value. Markets started to re-converge only when the refineries reopened, transportation channels were re-established and the CME extended the range of bars accepted for delivery on the exchange to include popular formats such as 1kg bars.¹²

Accounting for gold

Another important aspect in the valuation of gold in a portfolio is the way it is accounted for. Historically, CBs accounted for gold based on acquisition cost. In recent years, most central banks have updated their accounting policies to dynamically track gold's market value in order to express its portfolio diversification and inflation hedging properties. Those few CBs that still account at static prices should consider the benefit of alternative approaches.

Revaluations resulting from accounting changes can have profound effects. In December 1999, the IMF entered into separate but closely linked transactions with member countries that had financial obligations falling due to the IMF. In the first step, the IMF sold gold to a member state at the prevailing market price, and the profits from the sale were placed in a special account and then invested for the benefit of the Heavily

¹¹ LBMA Alchemist 95, The Bank's Golden Evolution

¹² Gold Market Snarled by Virus Lockdown as World Races for Haven <https://www.bloomberg.com/news/articles/2020-03-24/scramble-for-gold-sends-new-york-premium-to-a-four-decade-high> - Thoughts from a market professional: A modern Fairy-Tale: Gold, the Comex and the new Fools (of) Gold <https://www.linkedin.com/pulse/thoughts-from-market-professional-modern-fairy-tale-gold-ross-norman>

¹³ IMF: News Brief: Financing the HIPC and ESAF Initiatives September 27, 1999, <https://www.imf.org/en/News/Articles/2015/09/29/18/03/nb9962>

Case Study: Citi Gold Notes

Citi successfully structured a Gold Settled Note issued for a central bank seeking to generate yield from its gold reserves held at the BoE. The transaction used Gold (XAU) as investment currency, enabling Citi to pay positive interest on the investment. Under the transaction, Citigroup issued a Note to the central bank with a maturity of three years and a coupon of 0.20% per annum. In exchange, the central bank delivered a specified number of ounces of gold to Citi as the investment currency. The note also offered an option for the central bank to redeem it, either in gold or USD at maturity.

By investing in the gold note, the central bank generated yield on a quantity of gold that ordinarily would incur custody fees (negative yield), while keeping its economic and balance sheet exposure to the price of gold. This transaction highlighted the importance of gold as a reserve currency for central banks.

The Citi Gold Note is appealing for investors seeking fresh exposure to the price of gold, while earning a positive yield and carrying the credit risk of the issuer (Citigroup). In this case, the initial investment was in USD (rather than XAU) in exchange for a USD-denominated bond that replicates exposure to the gold price, pays a coupon and gives the right to delivery of gold ounces at maturity. This is potentially an alternative to other gold-tracking products, such as ETFs or certificates that incur custody/management fees while not paying a coupon (all subject to the investor accepting the liquidity and credit risk of the Citi Note). The Note also provides access to an accumulation of physical gold for future delivery to reserve managers that do not have an existing custody account.

Indebted Poor Country Initiative (HIPC) and Enhanced Structural Adjustment Facility (ESAF). In the second step, which followed immediately, the IMF accepted, at the same market price, the same amount of gold from the member state in settlement of that member's financial obligations falling due to the IMF.

The net effect of these transactions left the IMF's holdings of physical gold unchanged. No gold was released to the market, and thus there was no impact on the supply and demand balance. However, the IMF's gold holdings accepted in settlement of members' obligations (the second step above) was recorded at a higher value in the IMF's balance sheet.¹³

Generating returns from gold

Just like currencies or other assets, gold holdings can be deployed for yield enhancement to generate interest income or for monetization strategies to raise financing.

Yield Enhancement includes strategies that introduce an element of credit or market risk to gold in order to generate return: swaps, deposits and bonds fall into this category (Citi can offer a comprehensive range of such solutions).

Under a swap transaction, gold is converted into a currency of choice with the agreement to reconvert it back at a future date; the proceeds of the initial sale are invested in money markets instruments to generate a return. When the swap matures, both the currency and the gold are returned: the net yield of the transaction is the differential between the return generated by the currency investment less the cost of swapping the gold. This cost is known as contango if it is positive, as is normally the case for USD denominated swaps, or backwardation if negative, for example for EUR, CHF and JPY.

A currency can also be swapped into gold to generate a return on the currency itself. In this case, gold is acquired without the intention of holding it in the long term and is held only

Case Study: Gold Monetization

The CB enters into a Gold Sale and Purchase Agreement (GSPA) with Citi, with Citi purchasing LGD bars on a spot basis at the Bank of England, for example. The purchase price paid by Citi is subject to a haircut and the transaction includes a margining or hedging mechanism that guarantees protection if the value of the bars falls below the agreed price. The CB also enters into a forward transaction to buy back the same quantity and quality of gold at maturity at, or below, the market price (thanks to an embedded hedging mechanism). In addition, the CB agrees to make periodic coupon payments to Citi that are typically lower than those of government bonds with similar maturities. The duration of these trades can range from one to five years.

One of the key features of this solution is the embedded hedging mechanism that compensates the investor if the price of gold declines, effectively combining both financing and hedging in a single transaction.

for the duration of the swap (usually in an allocated account). The reserve manager buys the metal at inception, stores it and agrees to sell it back at maturity at a higher price that corresponds to the initial price plus contango. The net return on the transaction is contango minus the storage cost charged by the custodian. Such a trade has the added benefit that the investor holds physical gold for the duration of the trade as a form of collateral. Combining potentially higher returns and a mitigated credit risk profile, these swaps can be an attractive alternative to traditional money market currency deposits.

All swap transactions generate a credit risk exposure between central bank and bullion bank and would typically need to be documented under ISDA, sometimes limiting volumes and access to these products.

As an alternative to swaps, gold balances can also be leased via deposits placed with commercial banks following the same construct for other currency deposits. In this case, the central bank receives interest at maturity (paid either in USD or in gold) in exchange for taking the credit risk of the counterparty, as well as eliminating custody fees for the duration of the deposit. For added flexibility, Citi can also offer Gold Settled Notes (see case study), combining issuers and tenors of choice to generate coupons on the gold invested.

Gold monetization (see case study) refers to strategies that generate currency liquidity by leveraging holdings of metal, typically in the form of sale and repurchase transactions. CBs can raise financing using their gold holdings in an economically efficient way and without the need to sell it outright, which would result in the loss of the asset. Mobilizing bullion reserves requires careful consideration: Citi's proven solutions enable central banks to raise financing in a cost effective and prudent way.

Increasing and rebalancing gold reserves

The share of gold in the reserves of emerging market countries is much lower than advanced economies,¹⁴ and therefore there is potential for it to grow. While gold-producing countries have access to local production and can buy metal locally, other CBs need to purchase gold in the international market. Citi can assist by providing liquidity in spot and forwards as well as custom-made hedging solutions.

Changes in the price of gold have the effect of increasing or decreasing the share of bullion in the total value of reserves, potentially deviating from the desired allocation. Central banks can rebalance their holdings by operating sales and purchases in the market or by employing ad-hoc solutions like Dual Currency Notes.

¹⁴ WGC: A Central Banker's Guide to Gold as a Reserve Asset

Case Study: Gold Accumulation Notes

These notes are designed for reserve managers who want to build a gold position over time within a preferred price band while earning a yield on funding allocated for that purpose.

The central bank deposits USD with Citi in an interest bearing Note, which includes a mechanism that converts the USD into gold on a monthly basis (for example) within a pre-agreed price range, essentially locking in a maximum and minimum price for the duration of the note.

While the dollars are converted into gold over time, the CB would also earn a yield on the notional invested in the form of a coupon paid at maturity. Once the note matures and the investment has been fully converted into gold, the central bank has the flexibility to request the delivery of physical metal to a location of its choice e.g. BoE. These notes do not require an ISDA or credit line in order to transact.

Moreover, real rates are now at sub-zero levels, central bank balance sheets have reached unprecedented proportions and geopolitics are more fractured than for several decades. In such an environment, as during previous crises, gold will remain an indispensable central bank reserve asset. However, gold has the potential to work harder for CBs; using innovative financial tools it can enhance portfolio returns.

Case Study: Dual Currency Notes (DCNs)

These notes allow central banks to generate higher yields than traditional deposits while managing their relative exposure to gold and other currencies. The initial investment can be made in USD (or other currencies) as well as gold, and the notes include a mechanism that converts the notional invested from gold to USD (or from USD to gold), depending on a preferred conversion strike defined at inception. If gold appreciates more than the conversion strike at maturity, then the repayment is made in USD based on the conversion strike. Effectively these notes rebalance the allocation to gold if the gold price and the value of the holdings rises above a certain target level.

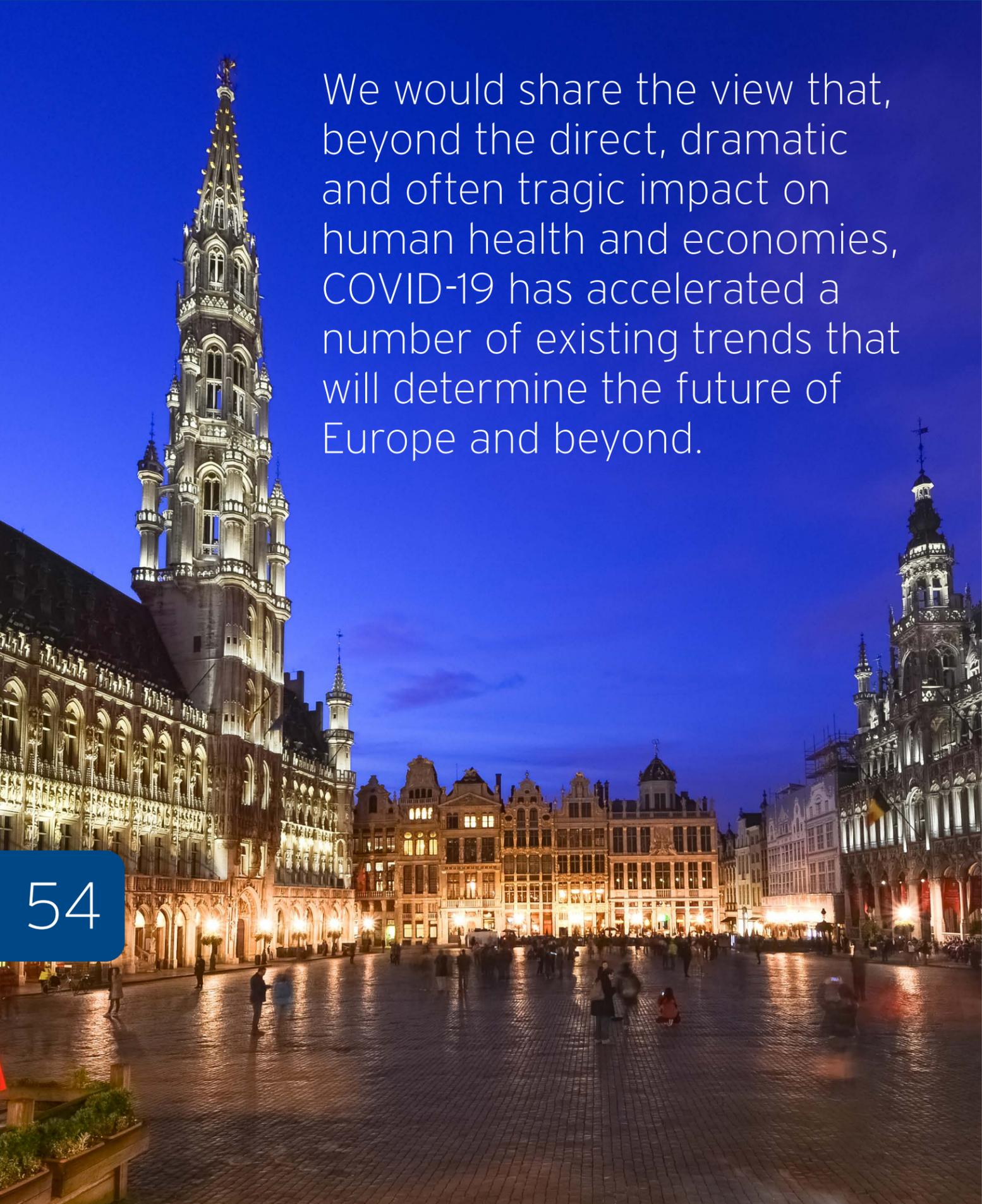
Alternatively, a reserve manager could make an initial investment in USD and set a target level for converting the USD into gold, and increase the gold allocation in the portfolio if prices decline below their target, while earning an attractive yield on USD.

Conclusion

While markets and economies around the world have begun to stabilize after the COVID crisis period there remains considerable uncertainty regarding the duration of the pandemic and the long-term outlook for the global economy. Moreover, real rates are now at sub-zero levels, central bank balance sheets have reached unprecedented proportions and geopolitics are more fractured than for several decades. In such an environment, as during previous crises, gold will remain an indispensable central bank reserve asset. However, gold has the potential to work harder for CBs; using innovative financial tools it can enhance portfolio returns.

Citi offers a range of gold solutions to help reserve managers to manage their gold more effectively. We work closely with managers to understand their objectives and enable them to follow best practice, as well as providing insights about market dynamics and opportunities in the gold market. ■





We would share the view that, beyond the direct, dramatic and often tragic impact on human health and economies, COVID-19 has accelerated a number of existing trends that will determine the future of Europe and beyond.

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Policymakers in Europe Take Action to Secure the Post-COVID Recovery

Since the beginning of the year, the health pandemic has, understandably, been the primary focus of policymakers throughout the world. We would share the view that, beyond the direct, dramatic and often tragic impact on human health and economies, COVID-19 has accelerated a number of existing trends that will determine the future of Europe and beyond. Moreover, while we are still in the storm, not yet able to tame the invisible foe, very real and understandable COVID-19 fears mask and distract from some major geopolitical developments. In that sense, and as an aside, read any polling on voter sentiment with extreme caution!

In Europe, after a shaky start with, for example, some borders closed between EU Member States, the response to COVID-19 has become more coordinated. The renewed sense of solidarity culminated in July when the European Council reached a historic agreement for a one-time €750 billion recovery fund, known as NextGenerationEU in Brussels circles. For the first time, the EU will finance grants and loans to Member States by borrowing from capital markets.

Reflecting the political significance of this agreement, the German Finance Minister has described the recovery fund as the start of a fiscal union, 'a sort of Hamiltonian moment'. Certainly, the Commission Proposal sets out a number of potential EU 'federal' taxes, known as EU Own Resources. Whatever is ultimately agreed - decisions will not be required this year - the European Commission tapping the capital markets on such a scale will have political consequences.

For many European politicians, the recovery fund is as an expression of a willingness of the European Union to do things differently, even, some have suggested, an expression of the EU's willingness to be a more assertive geopolitical actor.

Looking a little more closely at the detail, the biggest component of the fund is the €672.5 billion Recovery & Resilience Facility (RRF), made up of €312.5 billion in grants and €360 billion in loans. As you might imagine, the size of the fund, as well as the split between grants and loans, were two of the biggest elements in the negotiations between EU Member States. The conditions attached to the money also raised further debate, including 'rule of law' conditions, which proved most controversial.



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Of the grants, 70% (€218.75 billion) will be committed in 2021-2022 and the remaining 30% (€93.75 billion) in 2023. To access the funds, Member States need to prepare 'National Recovery and Resilience Plans', which must include both reform and investment proposals, be based on 2019 country-specific recommendations from the Commission and should focus on economic growth, job creation and social cohesion, along with the twin EU priorities of green and digital.

In terms of the putative 'federal taxes', the European Commission set out a number of options in its May 2020 Proposal, one of which has already been approved by Member States, an EU tax on non-recyclable plastic packaging waste. Other proposed taxes included an extension of the Emission Trading System to airline and maritime transport, a carbon border adjustment mechanism, which is a form of carbon tariff to ensure domestic environmental policies are not 'undercut' by more lightly regulated foreign imports, a digital services tax and an EU Single Market Levy, a tax on the larger companies that benefit most from the EU Single Market.

It is worth noting that the recovery fund will require ratification of all Member States through their national parliaments (but not technically the European Parliament, although it does have influence through its role in the general 7 year EU budget).

On September 16, 2020, Ursula von der Leyen gave her maiden 'State of the Union' address to the European Parliament. Naturally, the Commission President underscored the importance of a renewed EU Health Union, with various measures to strengthen cross-border coordination. In terms of the 'social market economy', amongst other things, Mrs von der Leyen explained that the Commission will work to complete the Capital Markets Union and the Banking Union: "Deep and liquid capital markets are essential to give businesses access to the finance they need to grow and invest in recovery and in the future. And they are also a pre-requisite to further strengthen the international role of the euro."

On the matter of 'responding more assertively to global events' Mrs von der Leyen said that an EU version of the US Magnitsky Act will be proposed, allowing sanctions if human rights are infringed. On trade, the focus was on revitalizing and reforming the multilateral system, with the EU looking to lead reforms of the World Trade Organization and World Health Organization.

In support of all of the above, the Commission President clearly and specifically addressed the European Green Deal and its fundamental role, not only for the imminent recovery, but also in the very way the bloc will prosper long into the future. Headlining the proposal was the new EU-wide goal of a 55% reduction in emissions by 2030, up from the current target of 40%. Indeed, 37% of NextGenerationEU will be spent directly on European Green Deal objectives and a target of 30% of NextGenerationEU's €750 billion to be raised through green bonds was also announced. This commitment takes green financing to the next level and will reinforce Europe's position as the largest issuer in green bonds worldwide. It serves as a clear message to the rest of the world of the importance the EU places on combating climate change: it will achieve climate neutrality by 2050, it will honor its commitments to the Paris Agreement and it will lead others in doing so.

Neatly abutting the green pillar, the Commission President also took stock of its digital twin, entreating policymakers and the private sector alike to make this "Europe's Digital Decade". Despite this theme being long established and widely endorsed, Europe has fallen behind. To date, all of the tech giants are based in China and the US; 40% of those living in rural areas are still without access to broadband connections; and the real data economy lies latent yet untapped with 80% of industry data being collected yet never used.¹ While the pandemic has taken a heavy toll, it has played an uncomfortable, yet vital, role in revealing weaknesses in the European system that have been neglected or ignored and in this digitization is not immune. To thrive in a post-COVID world, Europe must be

transformational and digitization will be key. It is therefore not surprising to learn that 20% of NextGenerationEU will be invested in the Commission President's 'Digital Decade'.

Given the historic sum enshrined in the recovery fund and its heavy focus on the environment and digital there is a clear message echoing from the corridors of Brussels; a robust desire to rebuild, rebuild quickly and, above all, rebuild in such a way that is future proof and does not leave anyone behind. This was not the case after the Global Financial Crisis of 2008. Since then, inequality in Europe has increased and become more entrenched, both socially and economically. These inequalities were borne out by COVID-19 with the most vulnerable individuals, areas and nation-states being the most adversely affected. However, the aforementioned themes can play a part in the reversal of the status quo and provide an opportunity that could bring multiple benefits to many of Europe's less developed regions, allowing them to finally mobilize untapped resources and accelerate their economic progression.

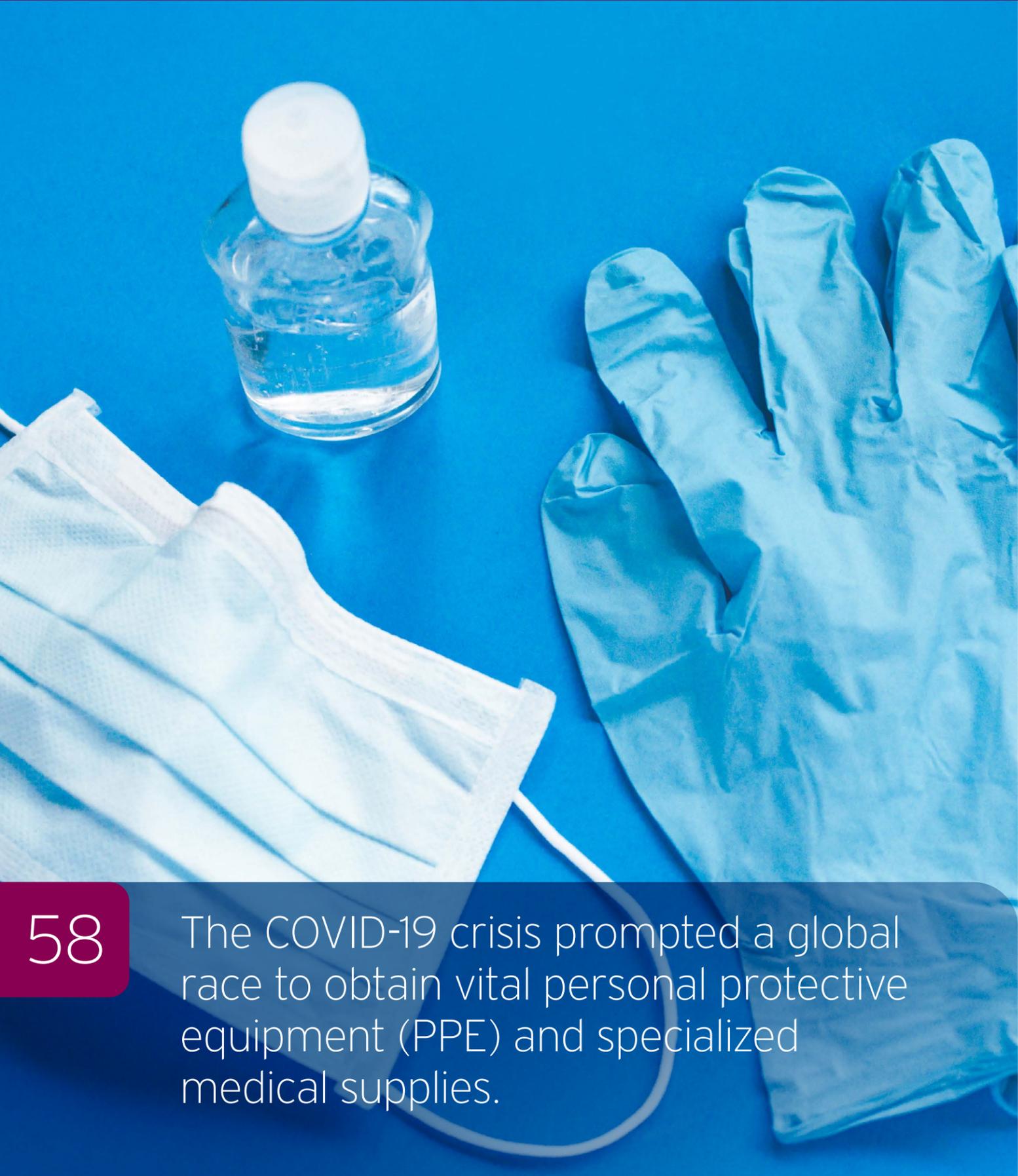
However, this is no mean feat for Member State governments. Despite the unprecedented support emanating from the highest echelons, national administrations now face the unenviable task of supporting a recovery whilst simultaneously dealing with a heavily inflated debt pile and much reduced revenue. McKinsey forecast that this could result in a worldwide deficit of \$10 trillion in 2020 and a cumulative shortfall of up to \$30 trillion by 2023. This will require a delicate and meticulous balancing act by policymakers; in order to "avoid disrupting the economic revival, fiscal measures must not come too early, but to avoid losing control of the fiscal trajectory, they should not come too late". However, if we have learned anything from the aftermath of the Global Financial Crisis it is that economic austerity and tapered investment are not the answer. The Commission President entreats Europe "to emerge stronger by creating opportunities for the world of

Given the historic sum enshrined in the recovery fund and its heavy focus on the environment and digital there is a clear message echoing from the corridors of Brussels; a robust desire to rebuild, rebuild quickly and, above all, rebuild in such a way that is future proof and does not leave anyone behind.

tomorrow and not just building contingencies for the world of yesterday". However, whilst valiant and emboldening in sentiment, this call to arms is fraught with challenges, none more so than the fiscal dynamics with which Europe (and the rest of the world) must now contend.

In conclusion, many of the recent EU initiatives have focused on achieving 'Strategic Autonomy'. What started in the heat of the COVID-19 storm in April as an understandable desire to "increase the strategic autonomy of the Union and produce essential goods in Europe" has taken on its own momentum. Precisely what this means we will learn over the coming months and years. ■

¹ "Closing the \$30 trillion gap: Acting now to manage fiscal deficits during and beyond the COVID-19 crisis", McKinsey & Company, 16 July 2020.



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The COVID-19 crisis prompted a global race to obtain vital personal protective equipment (PPE) and specialized medical supplies.

Secure, Efficient and Flexible Payments Are Paramount During COVID-19 and Beyond

Making safe payments has always been important for public sector entities. But unexpected purchasing requirements during the COVID-19 pandemic have been a valuable reminder of the importance of remaining vigilant and using proven secure payment methods.



Andy Taylor
Head of State & Local Governments, North America Public Sector Group, Citi

The COVID-19 crisis prompted a global race to obtain vital personal protective equipment (PPE) and specialized medical supplies. Governments, hospitals, law enforcement and emergency services, universities, and nearly every large corporation competed to procure the same limited supplies.

Manufacturers across the globe immediately sprang into action to market their goods; some other firms (often with no experience of PPE production) reconfigured their operations to produce in-demand equipment. Unfortunately, fraudsters and other dubious entities also entered the game, adding additional risk to an already challenging situation.



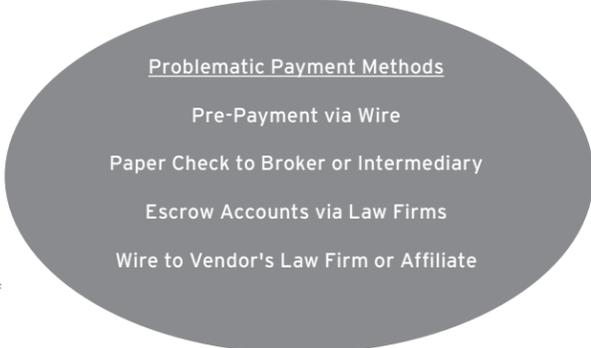
Unfulfilled PPE contracts leave states scrambling for supplies amid the coronavirus pandemic

After weeks of "wild west" wrangling between state governments for critical medical supplies amid the coronavirus pandemic, personal protective equipment still remains scarce for some frontline workers. Meanwhile case of fraud, waste and abuse are piling up.



States and Hospitals Are Sourcing Their Own PPE From China

States and hospitals aren't just counting on the federal government for personal protective equipment. They're wading into the import business themselves sourcing their own supplies from China.



FBI exposes coronavirus scam after 39M masks promised from overseas fail to reach California hospitals

The FBI uncovered an international coronavirus-fueled fraud scheme after more than 39 million masks promised to a powerful California union representing healthcare workers were never delivered to hospitals and other medical groups in the state.

The New York Times

Company Questions Deal by "Shark Tank" Star to Sell N95 Masks to Florida 4/22/2020

The company that makes the masks, 3M, said Daymond John's firm The Shark Group was not an authorized distributor and appeared to have been selling them at an inflated price.

For clients sourcing goods from new or unfamiliar suppliers, Trade Finance solutions can add security.

At Citi, we observed some risky transactions, such as pre-payment for goods without inspection; similar episodes were highlighted in the media at the time. For example, a U.S. State government delivered a paper check to a broker in a fast food restaurant parking lot. The broker then took a photograph of the check, sent the photo to the supplier in China, and goods were released. This transaction was successful. But in other cases, purchasers were not so lucky, as the headlines shown on the prior page demonstrate.

While supply of PPE and other medical equipment is catching up with demand, large purchasing organizations continue to need secure, efficient, and flexible payment methods, both for PPE and other goods. The following are three of the most effective ways for public sector entities to ensure safe, transparent and reliable payments.

Invoice review and payment is initiated by the client's bank and facilitated through the supplier's bank via the SWIFT network.

Certain suppliers may accept a standby L/C from the buyer's bank. This is a contingent obligation by the buyer's bank to make payment in the event the buyer fails to fulfill an obligation, such as failing to pay the supplier after receipt of certified goods. The standby L/C only gets drawn if the buyer does not complete its payment obligation, giving confidence to the supplier, especially in an unsettled economic environment. This payment method can also give buyers a negotiating advantage when bidding on limited supplies.

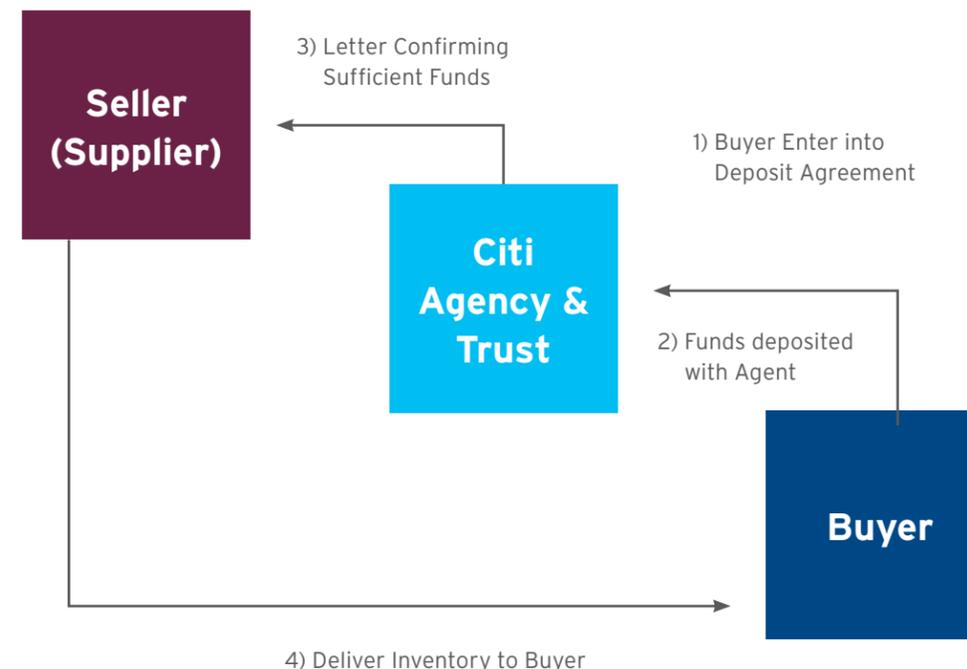
Both of these Trade Finance approaches eliminate the need for pre-payment, and are familiar to global suppliers.

Trade Finance solutions

For clients sourcing goods from new or unfamiliar suppliers, Trade Finance solutions can add security. Many large global suppliers are familiar with commercial letters of credit (L/C). An L/C is a payment undertaking issued by the buyer's bank in favor of the supplier, where the bank's creditworthiness is substituted for the buyer's: the bank promises to honor payment on presentation of documents that prove the supplier has performed its contractual obligations as specified in the L/C.

Agency and Trust solutions

Early in the COVID-19 crisis, many buyers sought flexible payment solutions that would allow them to both negotiate with suppliers, and to securely make payments to unfamiliar suppliers that lacked the ability to enter into L/C arrangements. Some buyers turned to Agency and Trust solutions to enable them to negotiate with suppliers and deliver payment. Under one Agency and Trust solution, a buyer enters into a Deposit Agreement with their bank as Agent. Funds are deposited with the bank, which then provides a letter to the buyer,



confirming adequate funds are earmarked for the transaction. This letter can be provided to potential suppliers seeking some form of guarantee or pre-payment, giving them confidence that payment will be delivered on receipt of goods. Once agreement is reached between buyer and supplier to transact, the buyer confirms goods are received and conditions met, and then instructs the bank as Agent to release funds to the supplier. Through this method, pre-payment to a unfamiliar supplier is avoided, while the supplier has confidence - through confirmation by a large global bank - that the buyer is liquid and earnest in its purchase request.

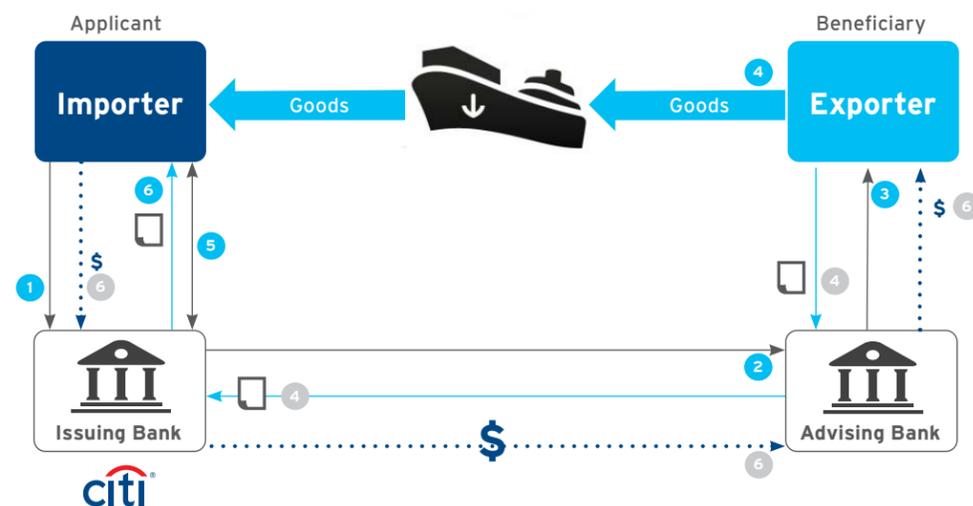
takes place. That makes them ideal for indirect B2B spend, including PPE (though VCA is dependent on the supplier's ability to accept card payments).

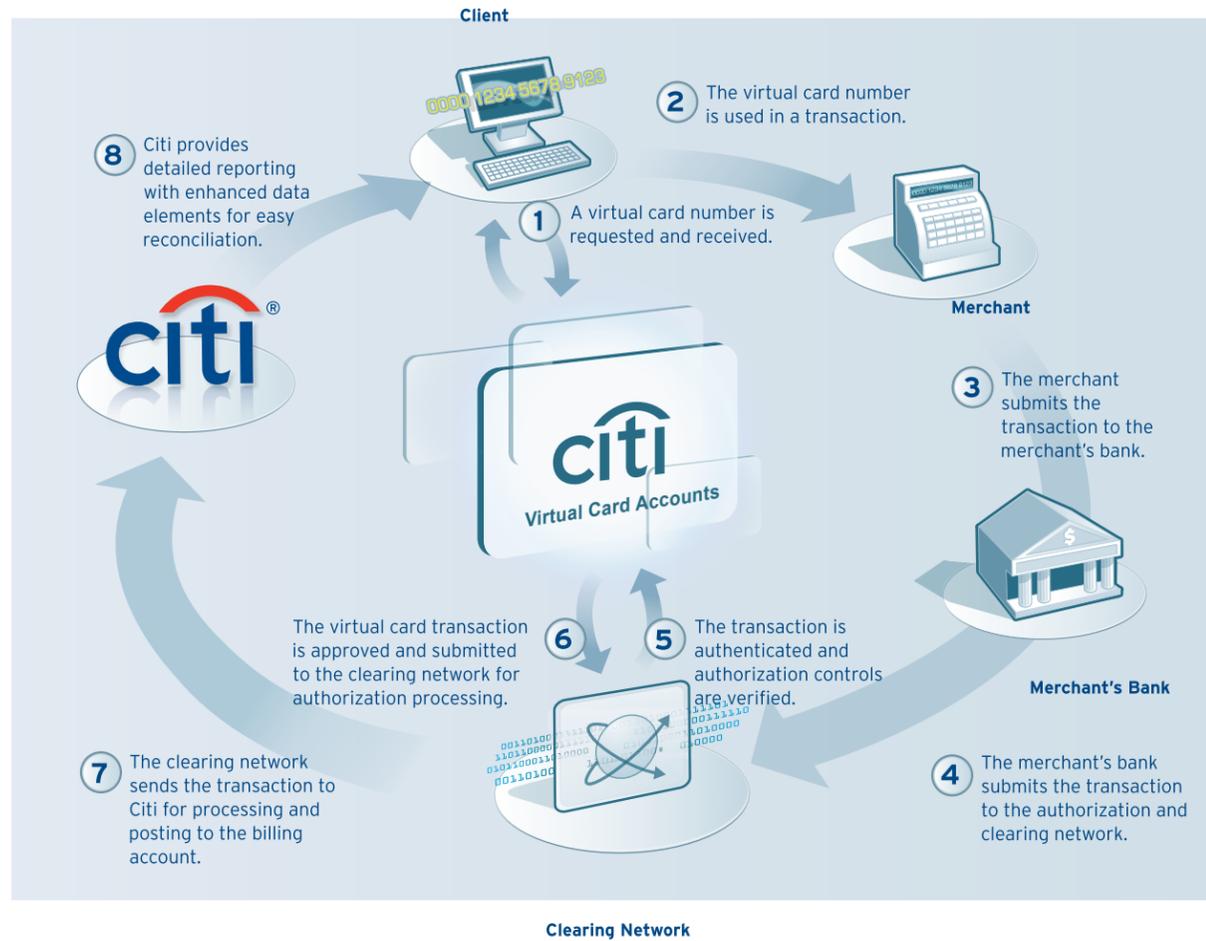
VCA seamlessly fits into existing procure-to-pay processes. It simply replaces existing bank transfers or EFT payments for a segment of payables where card acceptance is prevalent. Crucially, VCA offers transaction-level controls, with limits on the number of transactions (single- or multi- use), transaction amount limits (exact, maximum, or range) and validity periods (suppliers and merchant category codes) that provide comfort to buying organizations.

Virtual Card Accounts

Within the Commercial Card suite of products, Virtual Card Accounts (VCA) allow buyers to make safe, secure, and (potentially) recurring payments to suppliers (that may be either new or established relationships). VCA are a plastic-less electronic payment solution that generates a unique card number each time a transaction

VCA also delivers efficiency benefits as it offers client-specified data elements for each transaction, providing enriched analysis, reconciliation and allocation. As well as batch payments, VCA offers the option for individual payments online, providing greater flexibility. Payments are received within two to three hours and funds settled within 48 hours of authorization - significantly faster than check (which is subject to mailing time and clearing). The payer has no liability for fraudulent transactions.





Conclusion

While the COVID-19 crisis is ongoing, the provision of PPE and other medical equipment is now better organized. Most public sector entities have established relationships with suppliers they trust and are unlikely in the future to need to make purchasing decisions with great urgency and during a time of uncertainty. Nevertheless, treasury and purchasing organizations should continue to be mindful of payment security, efficiency and flexibility.

The use of Trade Finance, Agency and Trust and VCA solutions can help to eliminate fraud and should become part of the toolkit of treasury and purchasing organizations. Indeed, simply using these solutions does much to eliminate fraudulent suppliers: often they will be unwilling to sign up for a L/C or unable to process a VCA payment. Suppliers requiring payment by wire, and not entertaining any other payment alternatives, should raise a red flag for public sector entities making purchases. ■





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