

Lessons from the US for National Development Banks

Anglo-Saxon Practice Better Than Model

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OVERVIEW

- **Definition**
 - Government sponsored financial institution that improves on what markets are doing, i.e. remedies financial market imperfections
- **Four key characteristics of NDBs**
 - Objectives / Goals/ Mission
 - Funding
 - Ownership / governance
 - Assets, Liabilities, Risk management and other financing activities
- **Lessons for a new generation of NDBs**
 - Identify the problems they solved
 - Identify the solutions they achieved
 - Identify an innovations they created
 - Remaining problems or policy failures
- **US Experience:**
 - Small Business Administration
 - Export-Import Bank
 - Farm and rural economy
 - Counter-cyclical financing
 - Housing
 - Sub-National (Municipal) Public Finance
 - Education



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KEY CHARACTERISTICS

- OBJECTIVES OR GOALS

- Broadly stated

- Stable growth
 - Sustainable development
 - Greater equality
 - Accessibility (equal access) to credit

- Specified

- Long term credit
 - Fixed rate credit
 - Credit to remote areas
 - Targeted credit to specific sector, e.g. farming or housing
 - Credit to SMEs and microfinance institutions
 - Seed capital to new firms and farms
 - Risk management services, e.g. credit guarantees, insurance, hedging
 - Technical assistance



KEY CHARACTERISTICS

FUNDING for NDBs

- Issuing securities
 - equity/ stocks
 - bonds
- Loans
 - from private commercial banks (domestic)
 - from other private financial institutions (domestic)
 - from governments or other national development banks
 - from private international financial institutions
 - from IFIs
- Grants/ Appropriations from government
- Credit guarantees from government for private funding
- Retained Earnings



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KEY CHARACTERISTICS

OWNERSHIP and GOVERNANCE

- Corporation
 - Public ownership
 - wholly government owned and operated, though not a government institution
 - Private ownership
 - Private ownership with Government influence/control
 - Public-private ownership
 - government role exerted through, e.g., members on board of directors are government officials or are appointed by President or Governor; government defines mission in corporate charter; or through regulation
- Government Agency



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KEY CHARACTERISTICS

ASSETS, OTHER ACTIVITIES

- Loans to
 - municipal or subnational governments
 - other development banks
 - corporations
 - SMEs
 - farms
 - micro loans or loans to MFIs
- Loans: different instruments
 - Direct lending
 - Purchase loans, in whole or in part, from private lenders
 - Provide credit to private lenders who use certain qualifying loans as collateral for the credit they receive (differs from purchasing loans because it does not involve loan servicing except in case of default – differs from direct lending because it is collateralized)
- Technical Assistance
- Economic appraisal and evaluation



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THE U.S. EXPERIENCE:

LESSONS –

- PROBLEMS – what problems need solving
- SOLUTIONS – what measures used to solve problem
- INNOVATION – what innovations were used in solving problem
- FAILURES – what went wrong or failed to make improvements



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THE U.S. EXPERIENCE: Small Business Admin

Background

- The SBA was created in 1953 to consolidate several different programs created since the 1930s. This included the Reconstruction Finance Corp which was abolished in 1952.
- Initial mission was to make direct loans, guarantee loans and offer technical assistance to small businesses.
- Today the major program is the 7(a) loan guarantee program. No longer making direct loans, the 7(a) program provides guarantees up to 85% of a loan to a qualifying small business made by about 5,000 banks and other qualified lenders. 7(a) loans totaled \$43 billion at end of third quarter 2005. SBA has made over 1.2 million 7(a) loans and 1.5 million disaster loans since its founding.
- SBA makes direct loans to businesses as part of disaster relief. It also makes equal opportunity loans to businesses owned or controlled by those who are disadvantaged.
- SBA licenses and funds private venture capital businesses under the Small Business Investment Company program. Since 1958, SBA's venture capital program has put more than \$30 billion into small businesses.



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THE U.S. EXPERIENCE: Small Business Admin

Goal/ Objective

Makes direct loans, guarantee loans and offer technical assistance to small businesses. Also, makes disaster loans and loans to businesses owned or controlled by the disadvantaged.

Funding method

- Congress appropriates funds for operating expenses and program 'subsidies' which are the actual and expected losses from making, guaranteeing and insuring loans.

Ownership/ Governance method

Agency of the Federal Government

Assets/ Liabilities

Assets include direct loans, and SBA currently holds 219,000 loans with \$45 billion in principle. Its liabilities includes guarantees on loans by private lenders to qualified small businesses.



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THE U.S. EXPERIENCE: Small Business Admin

LESSONS – PROBLEMS

- Private capital and credit markets were not providing adequate credit to small businesses, especially those owned and controlled by the disadvantaged.

SOLUTION

- Government provided direct and guaranteed lending to small businesses.

INNOVATION

- Partial loan guarantees.
- Government licensed and funded private equity investment companies.

FAILURES

- Guarantees not efficiently priced
- Did not maintain adequate risk management. It does not properly monitor its credit exposure from direct lending and loan guarantees. Recent reforms including hiring Dun & Bradstreet to provide such risk management services.
- Some qualified lending partners of 7(a) are not adequately supervised as lending institutions (see GAO report, April 2006). Too high an incident of loan fraud by lending agents (SBA Inspector General 2006).
- The SBIC programs exposes funds to too much risk (SBA Inspector General 2006).



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THE U.S. EXPERIENCE: Export-Import Bank

Background

The Ex-Im Bank is an independent agency of the federal government. It was created in 1934 by executive order of Pres. Roosevelt and given a government corporate charter by the Ex-Im Bank Act of 1945.

Its mission is to support U.S. exports by providing export financing through its loan, guarantee and insurance programs in cases where the private sector is unable or unwilling to provide financing or to neutralize financing provided by foreign governments to their exporters when they are in competition for export sales with U.S. exporters.

In 2005, helped provide \$14 billion in financing for \$18 in US exports (of \$1,400 billion in exported goods and services) through 3,128 export sales transactions.

Forgiven \$165 billion to HIPC countries over last two years through Paris Club agreement.



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THE U.S. EXPERIENCE: Export-Import Bank

Key Programs

General Programs

- Direct Loans. Provides little direct lending in recent years and zero in 2005, but has considerable amounts outstanding.
- Loan guarantees. Provides 85% guarantee on commercial financing to foreign importers of US exports for loans of medium- to long-term maturities. This amounted to \$8.4 billion in 2005.
- Working capital guarantees. Guarantees loans to facilitate pre-export production. This amounted to \$1.1 billion in 2005.
- Export Credit Insurance. Provides 95% coverage on short-term and 85% coverage on medium-term insurance against losses on non-payment by foreign purchaser for commercial or political reasons. Ex-Im Bank authorized \$4.4 billion in export credit insurance in FY 2005.

Ex-Im Bank allowed \$100 billion in 'credit exposure' for 2006. Where direct loans count 100% against the exposure ceiling and guarantees and insurance count 25% of their notional amount. Its actual exposure through 2005 totaled \$63 billion, and reserves against loss were \$7.6 billion (12%). Of total exposure direct lending is 14% and exposure to the aircraft sector is 40%.



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THE U.S. EXPERIENCE: Export-Import Bank

Key Programs - continued

Small Business Programs

- Loan guarantees. Like general program but targeted for small businesses.
- Working capital. Provides guarantees on financing to small businesses from banks for pre-export working capital. Provided guarantees on \$1.1 billion for 2005.
- Export credit insurance. Provides insurance (95% coverage) to small businesses in export business that are exposed to credit losses when lending to foreign purchasers of their exports. 2005 policies totaled \$2.2 billion.



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THE U.S. EXPERIENCE: Export-Import Bank

Goal/ Objective

Its mission is to support U.S. exports by providing export financing through its loan, guarantee and insurance programs in cases where the private sector is unable or unwilling to provide financing or to neutralize financing provided by foreign governments to their exporters when they are in competition for export sales with U.S. exporters.

Funding method

Borrows from Treasury for short-term purposes and borrows from Treasury's Federal Financing Bank for medium- and long-term purposes. Also appropriations from federal government to cover operation expenses and expected future losses.

Ownership/ Governance method

Independent agency of the federal government.

Assets

Assets include direct loans and loan loss reserves. Liabilities include guarantees and written insurance policies.



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THE U.S. EXPERIENCE: Ex-Im Bank

LESSONS –

PROBLEM

- Not enough private credit to US traded goods sector
- Other governments providing subsidized credit to their traded goods sectors

SOLUTION

- Government provision of loan, loan guarantees and credit insurance in order to provide credit and promote private lending on terms that allow US firms to compete in global markets.

INNOVATION

- International risk management to control and manage exposure on programs.

FAILURES

- Violation of fair trade principles by providing trade subsidies to US firms.
- Lack of oversight to maintain environmental and human rights principles.



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THE U.S. EXPERIENCE: FARMING Farm Credit System

Congress passed the Federal Farm Loan Act in 1916, establishing the nationwide Farm Credit System — a network of credit cooperatives — to be a reliable source of funding for farmers, ranchers and aquatic producers during good times as well as bad. This included 12 regional farm land banks (FLBs) with most of the original capital supplied by the government. It was intended that the farmer-borrowers should ultimately own the co-op banks. Responding to farm price deflation following the first World War, Congress passed the Agricultural Credit Act of 1923, which added 12 Federal Intermediate Credit Banks (FICBs) to the Farm Credit System (one in the district of each land bank with capital supplied by the government). In 1933, Congress passed two more important laws: 1) legislation re-capitalizing the FLBs; 2) an act establishing 13 farm credit banks and a short-term credit delivery system through locally owned Production Credit Associations. Supervision of all 37 federal agricultural credit institutions was consolidated under the Farm Credit Administration. By 1968, all of the Farm Credit System lending entities had repaid their federal capital debt and were completely owned by their borrowers. The Farm Credit Act of 1971, plus 1980 amendments, expanded the range of services that Farm Credit institutions could offer to include rural home mortgages, leasing services, and international and rural utility lending.



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THE U.S. EXPERIENCE: FARMING

Goal/ Objective

Provide credit for farmers, farm enterprises and rural home ownership

Provide credit that is not susceptible to fluctuations in farm prices or the overall economy

Funding method

- The Federal Farm Credit Banks Funding Corporation manages the sale of System wide securities that raises funds in capital markets. (It was established as a stand-alone System institution, with two board members who are not affiliated with other System institutions and who are appointed by directors elected by the System banks after consultation with the Secretary of the Treasury and the chairman of the Federal Reserve Board.)
- Federal Agricultural Mortgage Corporation (Farmer Mac) raises funds by issuing bonds in the capital markets, and then lends to other FCS banks

Ownership/ Governance method

Farm Credit Administration oversees the various financial institutions

Assets

Loans to farms, farmers and rural residents for land, working capital, and rural homes



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THE U.S. EXPERIENCE: FARMING

LESSONS –

PROBLEM

- Not enough lending to farms
- Not enough lending for rural homes
- Not enough credit on terms appropriate for farming
- Lack of credit and capital to poor rural areas

SOLUTION

- Government sponsored credit programs for land, operating capital and rural homes
- Farm Credit Systems lending to participating financial institutions

INNOVATION

- Public provision of credit during economic downturn
- Public provision of credit to neglected areas and sectors
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FAILURE

- Substantial losses from loan defaults at various times has required additional government capital and reorganization of the system



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THE U.S. EXPERIENCE: COUNTER-CYCLICAL

Counter-Cyclical Lending – Reconstruction Finance Corp

The Reconstruction Finance Corporation (RFC) by the Hoover Administration in February of 1932 to make emergency loans to banks and railroads. Five thousand financial institutions, railroads, and life insurance companies received loans by July of that year, but too much was going to a few large firms. Authority was expanded that July to lend to municipal governments. Further expanded under Roosevelt in 1933, including authority to buy bank stocks (to provide fresh capital), and 7000 loans were made during 1933. Combined with other agencies in 1939 to form the Federal Loan Agency. After 1940, it made loans to foreign governments in support of war effort and to financial military construction in the US.

After the war, scandals when Senator Fulbright's Senate Banking Committee revealed in early 1950s evidence of favoritism and influence-peddling at the RFC. Reorganization followed, but the agency stopped operating in 1956.



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THE U.S. EXPERIENCE: COUNTER-CYCLICAL

Counter-Cyclical Lending – Tennessee Valley Authority

The TVA was established in 1933 to finance development and the provision of electrical power to rural areas along the Tennessee River. FDR wanted “a corporation clothed with the power of government but possessed of the flexibility and initiative of a private enterprise”.

Created in wake of financial difficulties experienced by privately owned utilities during the Depression. The TVA was a coordinated plan involving industrialization, soil conservation, reforestation, and the provision of electricity. It constructed dams (built 5 and improved 20), power plants and constructed a system of inland waterways in Tennessee, Alabama, Mississippi, Kentucky, Virginia, North Carolina, and Georgia. The TVA also engaged with communities by developing and selling fertilizers, electricity, building flood control projects, improving the navigation of the meandering river, malaria control, and engaging in programs of reforestation and soil conservation.

President Dwight D. Eisenhower later condemned it as an example of New Deal "creeping socialism."

Today is one of the lowest cost producers of electricity in the US.



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THE U.S. EXPERIENCE: COUNTER-CYCLICAL

Goal/ Objective

Counter-cyclical lending. It was established after the first World War to provide credit during difficult economic downturn that included deflation of farm prices.

Targeted investment to poor, rural areas. Investment also targeted to environmental issues such as soil conservation and waterways management.

Funding method

Government appropriations for grants and for working capital for lending operations. Also, retained earnings from successful lending activities.

Ownership/ Governance method

Government owned corporate structure

Assets

Loans and publicly owned infrastructure that often generated income from payments for services provided.



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THE U.S. EXPERIENCE: COUNTER-CYCLICAL LESSONS –

PROBLEM

- Not enough new lending during economic downturn, and as a result the downturn persists longer than it would otherwise. Sometimes caused by creditworthiness problems at financial institutions, sometimes by system illiquidity and sometimes by loss of confidence in capital markets.
- Privately owned utilities got into financial trouble
- Municipal government finance is pro-cyclical
- Lack of credit and capital to poor rural areas

SOLUTION

- Government sponsored credit creation through RFC
- Government funded investment through TVA

INNOVATION

- Provision of investment funds during economic downturn
- Indirect, targeted government lending through RFC
- Government sponsored corporation used to fund investments and rural development

FAILURE

- Some corruption emerged – or at least was detected - in 1950s



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THE U.S. EXPERIENCE: HOUSING

Federal Home Loan Bank System

Created in 1932 to increase supply of credit to home finance by advancing loans to member banks which post home mortgage contracts as collateral. This helped local economic development by assisting local lenders to extend affordable credit to their communities for more affordable-housing, small businesses, community development and agricultural funds. Community Investment Program (CIP) makes loan advances to fund community and economic development projects by providing below-market-rate loans to banks that extend long-term financing for housing and economic development that benefits low- and moderate-income families and neighborhoods.

Federal National Mortgage Association (Fannie Mae)

Established in 1938 as a wholly owned subsidiary of the Reconstruction Finance Corporation (RFC). Its mission was to add fresh capital to home mortgage market by providing a secondary market for mortgages insured by the Federal Housing Administration, and after July 1948, for some mortgages guaranteed by the Veterans Administration.

In 1968, split into privately owned (partially publicly controlled) Fannie Mae and government owned Ginnie Mae (Government National Mortgage Association). Ginnie Mae is managed by Department of Housing and Urban Development, a federal agency responsible for the federally aided housing programs and management and for liquidating functions of former FNMA.



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THE U.S. EXPERIENCE: HOUSING

Government National Mortgage Association (Ginnie Mae)

Ginnie Mae securities are the only mortgage-backed securities that offer the full faith and credit guaranty of the US government.

In 1970, Ginnie Mae solved problems of mortgage market inefficiencies by pioneering securitization. This involves buying similar mortgages, pooling them together, and then issuing claims on this pool in the form of mortgage-backed securities (MBS). Mortgage lenders pool packages of qualifying FHA, VA, RHS (Rural Housing Service) or PIH mortgages and convert them into securities. Ginnie Mae guarantees investors the timely payment of principal and interest on these securities.



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THE U.S. EXPERIENCE: HOUSING

Goal/ Objective

- Provide greater capital to mortgage market and greater supply of credit for home ownership
- Provide long-term, amortized, well collateralized, sustainable lending terms.
- Generate greater liquidity in mortgage market (by creation of a secondary market for home mortgages)

Funding method

Government appropriations working capital for loan purchases, line of credit from Treasury and authority to issue securities

Ownership/ Governance method

Ginnie Mae is government owned, Fannie and Freddie are public-private ownership-governance, and FHLBs are owned by the member banks (publicly regulated by the Federal Housing Finance Board).

Assets

Purchased home mortgages, loans to member banks and retained earnings



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THE U.S. EXPERIENCE: HOUSING

PROBLEM

Market imperfection in mortgage market included:

- shortage of capital in mortgage market – constrained supply of mortgages
- mortgages were illiquid assets
- varied underwriting standards
- loan terms were inconsistent with borrowers' ability to pay

SOLUTION

- Created a secondary market for home mortgages which put fresh capital back into market
- Established conventional loan terms for mortgages (30-year fixed, amortized, 80% down, income to cover 28% of loan service)
- Created the securitization process

INNOVATION

- Securitization

FAILURE

- Too successful, face major jealousy from major US banks
- Accounting problems, failure to properly comply with new derivatives accounting rules



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THE U.S. EXPERIENCE: MUNICIPAL MAINE BOND BANK (MBB)

Created in 1972 to provide public purpose financing to cities, counties, school systems, water districts, sewer districts and other governmental entities. Public purposes include school construction or renovation, road improvements, upgrades to sewerage treatment plants or water systems, landfill closures, purchase of public safety vehicles, and other municipal construction or renovation projects and capital acquisitions.

The Bond Bank enhances municipalities' access to national and international capital markets. The MBB sells tax-exempt bonds and taxable bonds under its name and uses the funds to lend directly to localities.

Municipalities apply for credit to the MBB which evaluates their proposals for legal and economic validity. Borrowers must also get approval from their own governing entity. The MBB consolidates credit applications from eligible municipals and then sells bonds on their behalf under the MBB name. The larger issuance creates greater investor interest because of greater liquidity and lower underwriting costs (due to volume). It also has a high credit rating (AAA by Standard & Poors and Fitch, and Aa1 by Moody's) which helps lower borrowing interest rates. The MBB can issue a bond representing a single municipality if the borrowing needs are great enough.



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THE U.S. EXPERIENCE: MUNICIPAL

Goal/ Objective

Provide public purpose financing to cities, counties, school systems, water districts, sewer districts and other governmental entities.

Funding method

Issues tax-exempt and taxable bonds in the capital market.

It does not receive any direct appropriations from the State, although it does receive grants from the State for administering the Clean Water Act and Safe Drinking Water Act.

Ownership/ Governance method

The MBB is an independent agency of the State of Maine. It is administered by a board of commissioners that include the Treasurer of State, Superintendent of Banking and three commissioners appointed by the Governor. It is set up as a corporation that is wholly owned by the State.

Assets

Capital in the form of retained earnings.



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THE U.S. EXPERIENCE: MUNICIPAL

PROBLEM

Municipal bond market is inefficient in several ways. The small, heterogeneous issues reduce liquidity. There are high costs for underwriting as well as for secondary market trading in OTC markets. (See Dodd 2005). The tax-exempt program creates further inefficiencies by making bonds attractive to only high-net wealth individuals with US tax liabilities.

SOLUTION

- Create greater homogeneity (and hence liquidity) and enhance credit rating in order to lower borrowing costs.

INNOVATION

- Consolidate municipal government public purpose borrowing needs into large, higher credit rated issuances.
- Fewer, larger issuances offer lower underwriting costs.
- Larger, homogeneous issues generate greater liquidity.

FAILURE

- Too successful, face major jealousy from major US banks
- Accounting problems, failure to properly comply with new derivatives accounting rules



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THE U.S. EXPERIENCE: EDUCATION

The history begins with the National Defense Education Act of 1958. That law authorized the appropriation of \$295 million over the next four years, to provide capital for student loans to be made by colleges, with the institutions putting up \$1 for each \$9 in capital from the federal government.

- National Direct Student Loan program involves 3,400 universities, colleges and educational institutions.
- Guaranteed Student Loan Program created in 1965. Federal government covered 80% (later 100%) of states' losses on their student loan programs.
- Student Loan Marketing Association created in 1972. Its function is to provide a secondary market in student loans by 1) buying student loans from banks and other lenders, thereby becoming the owner of the loan and the one responsible for collecting it when due, and 2) lending to banks, up to 80 percent of the face value of the student loans made by that bank, with those loans being the collateral. The effect is to inject fresh credit into banks and other lenders so as to increase the supply of student loans.



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THE U.S. EXPERIENCE: EDUCATION

Goal/ Objective

- Provide direct loans to students and credit to qualified financial institutions providing credit to students.
- Loan terms that were affordable and enabled the student to repay loans without excess burden following their education.
- “To assure that all qualified students in need of an educational loan are able to obtain one, and that repayment arrangements are manageable when the borrowers leave school.”

Funding method

Initial capital was in form of a line of credit to Treasury overseen by HEW (Department of Health, Education and Welfare – since abolished). Government appropriations working capital for loan purchases, line of credit from Treasury and ability to issue securities.

Ownership/ Governance method

Government owned corporate structure, later privatized with some retained government control. Initially organized as government sponsored private corporation where stockholders limited (initially) to financial institutions and educational institutions. President of the US appoints 7 of 21 board members.

Assets

Purchased



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THE U.S. EXPERIENCE: EDUCATION LESSONS

PROBLEM

Private lenders unwilling to make long-term loans to individuals for education (problems with lack of collateral given the abolition of slavery).

SOLUTION

1. provision of credit and subsidized credit for the purposes of higher education
2. attract private capital into the process
3. creation of a secondary market for student loans
4. securitization of student loans

INNOVATION

- Provision of credit to allow greater access to higher education as well as job training
- Credit risk sharing between government, lenders and borrowers

FAILURES

- Subsidies have proven difficult to structure so that banks do not make excessive risk free profits.
- Not really attracting private capital because it is just a pass-through of federal government credit that quickly replaces any private sector capital involved in initial lending.



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LESSONS FROM THE U.S.

1. Provide credit in areas and to sectors that were denied or inadequately supplied
2. Provide credit and seed capital during times of economic distress in order to conduct more effective counter-cyclical economic policy
3. Create new products that provide solve old problems with illiquidity, concentration on credit risk
4. Direct credit flows to important sectors by providing subsidies or credit guarantees or credit enhancements



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