



Development Centre Studies

Guaranteeing Development?

THE IMPACT OF FINANCIAL
GUARANTEES

By James Winpenny



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FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Garantir le développement ? L'impact des garanties financières

Foreword

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Acronyms

AFD	<i>Agence Française de Développement</i> (French development agency)
AfDB	African Development Bank
AsDB	Asian Development Bank
BOOT	Build, Own, Operate, Transfer
BOT	Build, Operate, Transfer
CRG	Credit Risk Guarantee
DAC	Development Assistance Committee (of the OECD)
DCA	Development Credit Agency (of USAID)
DFID	Department for International Development (of UK)
EBRD	European Bank for Reconstruction and Development
ECCGD	Export Credit Guarantee Department (of UK)
EIB	European Investment Bank
FMO	Dutch Development financing institution
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	International Financing Institution (also MDB, MFI)
IsDB	Islamic Development Bank
KfW	<i>Kreditanstalt für Wiederaufbau</i> (official German investment bank)
MIGA	Multilateral Investment Guarantee Agency (of the World Bank)
MDB	Multilateral Development Bank (see MFI, IFI)
MFI	Multilateral Financing Institution (see MDB, IFI)
ODA	Overseas Development Assistance
OPIC	Overseas Private Investment Corporation (of US)
PCG	Partial Credit Guarantee
PIDG	Private Infrastructure Development Group
PPP	Public-Private Partnership
PRG	Partial Risk Guarantee
PRI	Political Risk Insurance
PSP	Private Sector Participation
RMI	Risk Mitigation Instrument
S&P	Standard and Poor's
USAID	United States Agency for International Development

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The study has drawn on a number of written documents which are fully acknowledged in the text and listed in the Bibliography. Two, in particular, stand out for their topicality and relevance for this study: the PricewaterhouseCoopers report for the World Bank (2003) and the report by Michael Jordan for the Private Infrastructure Development Group (2004). The study has greatly benefited from both of these.

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Preface

The world community has pledged to support large investments in infrastructure to meet the Millennium Development Goals. The usual sources of development finance are unlikely to expand enough to cover the large sums involved, and will need to be supplemented by non-conventional means. At the same time, investors, operators and lenders – local as well as international – have become more risk-averse than they were ten years ago. Guarantees are potentially part of the financial solution, leveraging the necessary flows by reducing the risks incurred by the parties directly involved. The Camdessus Panel recently endorsed an expansion in the use of these instruments in the water sector and the G8 Governments meeting at Evian in 2003 asked the World Bank to undertake a peer review of the relevant products and practices of the major multilateral development agencies.

Guarantees of various kinds have been available from leading international financial institutions, national governments and private insurance companies for some years, and these products are well recognised in the markets. Their use as tools of *development*, rather than *commercial advantage* is of more recent origin and gives rise to different considerations, some of which are explored in this study.

Although guarantees and insurance products are a familiar stock in trade in the specialist financial markets, they are less well understood in the development community. Indeed, there is suspicion in some quarters – which this study seeks to allay – of a fuller recognition of the value of guarantees as a development tool alongside conventional ODA. The study pleads for an assessment of guarantees in the broad context of evolving local financial and capital markets. Although they may introduce distortions of their own, they are justified if they compensate for serious and growth-retarding market and policy failures in capital markets. But they cannot “swim against the tide” if other necessary preconditions are absent.

I believe the Development Centre is uniquely well placed to promote the further study and discussion of this topic by virtue of OECD’s membership and our ability to bridge the different constituencies from aid, commercial, private financial and development policy circles.

The financial support of the French Government for this study is gratefully acknowledged.

Louka T. Katseli
Director, OECD Development Centre
August 2005

Chapter 1

What the Study Aims To Do, and Why

Overview: Aims and Scope

The context of this study is a concern to reduce the risks perceived by lenders and investors in developing countries, and its focus is on the tools available to outside agencies for mitigating these risks.

Its specific purpose is to describe the financial instruments involved in public guarantees, give a statistical assessment of the extent to which they are actually used, analyse their potential and assess their likely developmental impact, where possible referring to case studies of where they have been used.

Investors are confronted by many kinds of risk¹. Some risks are generic to the country concerned, such as political instability, terrorism, expropriation and other political intervention, devaluation, and restrictions on the conversion and transfer of foreign currency. Other risks are more commercial in nature, and arise from the particular activity being undertaken, and the specific agencies being dealt with. These include delays or default in payment, adverse decisions by an economic regulator, a misjudgement of demand or costs of the project, etc. Certain sectors are more prone to these problems than others, and are perceived as more risky.

There are various approaches to reducing risk. Risky events can be made *less likely*, for instance the appointment of a competent and independent regulator should reduce the probability of arbitrary or politically biased adverse decisions. An investor can create a *balanced portfolio* of assets, in the expectation that bad fortune in one will be offset by better luck in another.

Projects can be deliberately *counter-balanced* so that the same event which disadvantages one would normally benefit another. Moving from the “real economy” into the world of financial engineering, lenders and investors can take out *insurance* against specified risks, in exchange for payment of a premium or fee.

This study focuses on the last of the above approaches. It examines the insurance and guarantee² schemes used by multilateral and bilateral development banks and agencies in order to stimulate local capital markets and investment in infrastructure. The organising principle followed in the study is the *type of risk* being mitigated, and the four broad types are *political*, *contractual/regulatory*, *credit* and *foreign exchange*. Some guarantees are intended to promote specific projects, others benefit multiple loan programmes, such as microfinance lending and educational loans. Another category, covering credit risk, aims at *credit enhancement* of institutions (such as banks, companies or municipalities) issuing bonds or other securities. If successful, this latter type of guarantee stimulates capital market development through the creation of new savings and lending instruments.

Guarantees should benefit both sides in a loan or investment transaction. Lenders enjoy greater security in making their loan, while borrowers are able to obtain capital on better terms. Equity and portfolio investors have reduced downside risk and are able to expand their investment opportunities, while their host partners can attract more outside interest, also on improved terms. Equity investors can also be borrowers, as where a company borrows to finance part of its investment or acquisition.

First, a word on terminology: what do we mean here by “investment” and “guarantees”? The term *investment* is often used as a synonym for all types of financing for capital development, as well as the actual expenditure on the plant, machinery, etc. involved. This confounds the act of investment with the means of financing it. Used in this way, the term confuses a variety of different activities, undertaken by different parties with a variety of motives and risk exposure.

“Investment” in a factory or water works by the company that is building, acquiring and/or operating it is very different from “investment” by a commercial bank extending a loan to that company, or “investment” by someone purchasing a bond issued by a company, government or municipality. The first is an act of physical capital formation or a transfer of asset ownership, while the others are examples of different ways of financing the transaction. “Investment” in the financial sense also has very different implications, depending on whether it consists of equity, loan finance, or the purchase of fixed interest securities, and the variants of these basic forms. Box 1.1 sets out some basic definitions.

Box 1.1. Definitions of Basic Terms

This study will use terms in the following senses:

Investment: addition to the value of capital equipment³. More generally, capital formation in the sense of spending on land, buildings, machinery and other physical and human assets, or the acquisition of these assets from their previous owners.

Investor: any public or private company or agency, or individual, undertaking “real” investment in the above sense.

Lender: an individual, bank, company or other financial institution making a loan to another individual or entity under a clear contract and legal requirement for repayment.

Equity investor or shareholder: person or institution acquiring or holding an equity share in a company.

Direct foreign investment: situation where a foreign investor owns 10 per cent or more of the ordinary shares or voting power of a company.

Portfolio investor: person or institution holding a fixed-interest security, such as a bond, with a predetermined yield and claim on company revenues senior to those of an equity shareholder. Alternatively, a minority shareholder with less than 10 per cent of the ordinary shares or voting power in a company.

Private participation: situation where a private company or investor bears a share of the project’s operating risk. A foreign state-owned enterprise is considered a private entity. (World Bank/PPIAF, 2003a).

Guarantees: Guarantees and insurance against political, contractual/regulatory, credit and foreign exchange risks. This includes Partial Credit Guarantees, Partial Risk Guarantees, MIGA insurance products and schemes with a similar purpose offered by bilateral development agencies.

The focus of the study is on guarantees primarily with a developmental motive aimed at improving access to finance for long-term investment by local governments, firms and other institutions. By definition, this includes all products offered by the IFIs, and selected schemes of bilateral development agencies. The criterion for inclusion is that the operation, if it were to have been financed directly by donors through concessional credits, would be considered as ODA.

Export credit insurance is excluded, since this normally covers only payment risks for the export of goods and services by firms resident in the country of the agency concerned. Such schemes, operated by all the major exporting countries, have a strong national commercial motive, and apply to *suppliers' credits*, whereas the development guarantees used for comparable purposes and considered in this study typically apply to *buyers' credits*.

Figure 1.1 delineates the scope of this study, while Figure 2.1 in Chapter 2 contains examples of schemes in the different categories.

Figure 1.1. Scope of the Study
Shaded area = excluded from study

Type of risk	Development motive		Commercial motive	
	IFI	bilateral	official	private
Political	x	x	x	x
Contractual/regulatory	x	x		x
Credit	x	x	x	x
Foreign exchange	x	x	x	

IFI = international financing institution (e.g. World Bank, IADB).

Bilateral = official bilateral agency (e.g. USAID, AFD, DFID).

Official = public agency for export credit (e.g. Hermes, ECGD, EximBank, COFACE).

Private = private insurance company.

Practically all governments provide (*sovereign*) guarantees to official agencies and sub-sovereign entities such as parastatal enterprises and municipalities for their bond issues and other borrowings. This study is, however, confined to guarantees given by *multilateral and bilateral development agencies*, and does not include *national* guarantees, important though these are in many countries. This does not mean that the subject matter is restricted to guarantees only supporting *international* lending and investment flows. They can also be used to promote the development of local capital markets, enabling sub-sovereign entities to raise local money more easily, and encouraging microfinance initiatives, with local firms as their main target group.

The study also considers guarantees in the context of other methods of reducing the risk of investing and lending in developing countries, e.g. participation in syndicated loan offerings by IFIs (B loans), and the various ways of reducing foreign exchange risk, amongst others. It is mainly concerned with incentives for the development of public infrastructure and local capital markets, including microfinance. The case material includes examples from the water sector, following the concerns of the Camdessus Report (see below, and Box 1.2), but draws on the experience of other sectors too.

Guarantees can benefit both public and private parties to investment and financing decisions, on both sides of the transaction. The unqualified use of the term *private* financing and investment fails to reflect the spectrum of hybrid forms on display (Figure 1.2).

Figure 1.2. **Private or Public?**

The intention of this figure is to illustrate the range of different parties to a loan or investment transaction, across the full range of the public-private spectrum, plus other categories which defy this simple dichotomy. A guarantee could in principle benefit any of the parties listed. The list is drawn up for illustration only, and is not meant to be comprehensive.

Lender/investor	Instrument	Borrower/host/recipient
Private Banks; Individuals; Bondholders; Companies; Institutional investors;	Loans; Direct investment; Asset acquisition Bonds; Fixed-interest securities; Portfolio investment; Equity investment; Concession agreements BOTs, BOOTs, etc;	Private Companies; Banks Trusts Public Parastatals Publicly Owned cos. State banks Utilities Central government; Municipalities; Other sub-sovereigns;
Public State banks; Publicly Owned commercial banks; Public pension funds; Parastatal companies;		Mixed/hybrid Jointly Owned banks and companies;
Mixed/hybrid Companies and banks with mixed ownership		Special purpose vehicles BOTs, BOOTs Trusts
Public international IFIs Bilateral agencies		Not-for-profit bodies Co-operatives Charities Trusts NGOs
Charitable bodies Trusts Charitable bodies NGOs		

Lenders can be either private or public. Loans on market, or market-related, terms can be from private, public or public international development banks or other financial intermediaries. Portfolio investors, such as bondholders, and equity investors can likewise be from across the public-private spectrum. There is a further complication where banks are state-owned but act in a fully commercial manner (and there is a corresponding situation amongst investing or borrowing companies which have a mixed or public ownership, but which have a strongly commercial ethos).

Borrowers can also come from any part of the ownership spectrum, whether it is for commercial bank loans or the issue of fixed-interest securities, e.g. corporate debentures⁴ or municipal bonds. The movement for *private sector participation* (PSP) and *public-private partnership* (PPP) has also caused a blurring of the basic public/private divide. In infrastructure concessions the assets formally remain in public ownership, though in other key respects the operation can be considered private, while in BOTs and BOOTs the asset starts in private ownership but then transfers to the public domain.

Growth of Concerns about Investment Risk

Guarantees are capable of benefiting investment and financing of all types – public⁵ and private, national and international. However, for various reasons, private international capital flows have become the bellwethers⁶ for the state of investment and capital markets in the developing world. These flows are relatively transparent and are quick to respond to perceived changes in the political and economic climate. The trend in international capital flows is indicated in Table 1.1.

The flow of private capital is highly concentrated by region. In 2003, for instance, Europe and Central Asia accounted for 27 per cent of the total, East Asia and the Pacific for 35 per cent, and Latin America and the Caribbean for 27 per cent. In contrast, South Asia, the Middle East and North Africa, and sub-Saharan Africa only reckoned 19 per cent between them.

Net private capital flows to developing countries rose steadily during the 1990s, peaking in 1997/8, with foreign direct investment (FDI) the major component. The subsequent decline was mainly due to a sharp fall in debt finance, which actually became negative in 2002. The decline was triggered by the financial crises in major emerging markets (East Asia, Russia, Argentina) accompanied by major devaluations (e.g. Argentina, Indonesia, Philippines).

Table 1.1. **International Private Capital Flows to Developing Countries, 1995-2003**
\$ billion

	1995	1996	1997	1998	1999	2000	2001	2002	2003
FDI	105.3	127.6	171.1	175.6	181.7	162.2	175.0	147.1	135.2
Debt	76.1	84.6	93.9	107.2	38.4	9.9	2.2	-8.1	4.34
Portfolio inv.	17.3	32.9	22.6	6.6	12.6	12.6	4.4	4.9	14.3
Total	176.3	242.2	277.9	269.2	216.8	180.0	174.2	153.8	168.2

FDI = foreign direct investment, net

debt = net long-term debt

portfolio inv. = foreign portfolio investment

Source: World Bank Global Development Finance 2003 online database. Quoted in Jordan (2004).

Investor pessimism was reinforced by the economic downturn in the major industrialised countries in 2001/2 which reduced the profitability of a number of multinational companies that had been active in FDI. There were also at this time some major corporate scandals, the events of 11 September 2001 and subsequent heightened terrorism alerts, etc.

Compared to the fluctuations in the flows of debt finance, foreign direct investment has been fairly robust. A major influence on this has been shifts in attitudes towards Private Participation in Infrastructure (PPI) projects. The World Bank's Project Database on PPI records the ebb and flow of investment in infrastructure projects newly owned or managed by private companies in developing countries⁷. Over the period 1990-2001, developing countries transferred to the private sector the operating risk for c. 2500 infrastructure projects, representing investment commitments of \$750 billion. Investment in PPI projects grew rapidly from 1990 to a peak of \$130 billion in 1997, since when annual flows have fallen by more than half (World Bank/PPIAF, 2003a; Harris, 2003).

Many projects have been renegotiated, cancelled or nationalised, and in some cases there has been a popular backlash against privatisations. In the electric power sector, which led the earlier boom, there have been widespread problems with independent power plants (IPPs). In the water sector, a few of the largest concessions have run into serious problems, mainly because of major devaluations in their host countries. There are other specific reasons why the earlier level has been difficult to sustain – e.g. the large one-off privatisations in electricity and telecommunications in Brazil.

Current levels of PPI investment, though lower than previously, are still substantially higher than before 1995. Moreover, there are preliminary signs of a revival in PPI in 2003, led by growth in power and transport (Jordan, 2004).

As already noted, commercial bank lending to developing countries has declined to a very low level. This was partly due to heightened risk awareness and a reaction to general market sentiment, influenced by the above mentioned events. Certain structural changes have occurred in this market, leading banks to increase their emphasis on fee-earning work, and avoiding credit risk on their balance sheets. Project finance is increasingly scarce since the number of international banks offering project lending has shrunk, and those remaining are more risk averse. Certain banks, formerly active in these areas, have run into liquidity difficulties, and all banks are required by the Basel New Capital Accord⁸ to make adequate capital provision for their exposure in emerging markets. This has dampened the enthusiasm of many banks for further lending in developing countries.

Water – An Obstinate Case

The water sector exemplifies many of these problems. It has never attracted more than a small proportion (perhaps 5 per cent) of international capital flows for infrastructure, and still depends for most of its investment capital on government subsidies. In addition to the general problems recounted above, water has the sector-specific drawbacks of high capital intensity, low project returns, delayed cash flow, heavy political interference and unusually severe contractual and regulatory problems, amongst other handicaps. A number of the largest international water operators faced a shareholder backlash against losses suffered in overseas markets, and most of these companies are now focusing on core operations, to the detriment of new overseas ventures.

Against this unpromising background, the UN's Millennium Development Goals for water, subsequently extended to household sanitation, are likely to require a doubling of the flow of finance into these areas.

The World Panel on Financing Water Infrastructure, chaired by Michel Camdessus, was formed to study this problem and produce proposals for meeting its financing needs. Amongst its other proposals (Box 1.2) were a series of recommendations addressed to relevant agencies for facilitating the use of guarantees for this purpose (Winpenny, 2003).

Box 1.2. The Camdessus Report: General Themes

- Attainment of the Millennium Development Goals for water and sanitation should be adopted as the main goal and performance target by governments, donors, international financing institutions (IFIs), NGOs, and other concerned parties.
- National public funding is, and for the foreseeable future will remain, the main source of investment finance for this sector in many countries. National governments should raise the priority of the water sector in their national investment strategies and make their funding of it more reliable.
- Donor governments and external agencies should aim to make substantial increases in the share of water in their total commitments, improve the co-ordination of their activities in the water sector and use their funds as catalysts to mobilise other flows.
- Sub-sovereign entities, such as municipalities, regional water boards and water utilities, were crucial in the campaign to raise more finance. These bodies need to reform to generate more funds of their own and to become more efficient and creditworthy. Central governments should re-examine fiscal and financial relations with sub-sovereign entities, making their transfers more predictable and transparent, and helping such bodies to tap capital markets directly. In turn, IFIs should remove obstacles to lending to sub-sovereigns.
- Water projects can be complex and problematic, are often too small to attract ordinary project finance, and their transaction costs are high. To help overcome these hurdles, revolving funds should be created to fund the public preparation and structuring costs of complex projects. “Best practice” and “model” clauses should be written for legal agreements, especially those involving private participation.
- Foreign exchange risk is one of the main deterrents to the use of external finance for water, and is difficult to mitigate under current arrangements. To by-pass this risk, local capital markets should be encouraged as a source of local currency funds. Various measures can contribute, such as the use of credit rating agencies for local borrowers, issue of local currency bonds by IFIs, use of guarantees and other forms of risk mitigation by IFIs, strengthening of development banks and other local financial intermediaries, etc. A new Devaluation Liquidity Backstop Facility should be piloted.
- Better cost recovery from users is vital. However, full cost recovery is unlikely to happen soon in all cases, and in the meantime many governments will continue to subsidise water service providers. The Panel endorsed the concept of “sustainable cost recovery”, consisting of improved efforts to raise revenues from users, with residual subsidies applied in a predictable, transparent and targeted manner.
- The water sector lacks credible and effective institutions. Governments, donors, agencies and others involved need to foster capacity-building in water institutions by such means as direct funding of partnerships (both public-private and public-public), creating trust funds for financing expertise, support for training, professional exchanges, peer-group scrutiny, etc.
- The choice of organisational model for the water sector is a matter for local decision, and the Panel had no preconceptions on this issue. Where countries are keen to tap the expertise and capital of private operators, the various parties should work within a clearly defined and transparent policy framework, including regulation. Integrity standards should be developed amongst the interested parties and the award and implementation of contracts should be fully transparent. Public funds should be available for associating with private finance in transparent and acceptable ways. A special effort should be made to involve local private companies, including small-scale operators.
- The creation of Decentralised Funds should be considered to assist financing at grass-roots level from local initiatives and using local credit sources.
- Governments, agencies and other key players should be held to account for their commitments and performance against the MDG criterion. Donors and IFIs should report on their performance in relation to commitments. A “control tower” and group of “wise persons” should provide international monitoring.

Source: Winpenny (2003).

The theme was taken up by the G8 governments, meeting in Evian in June 2003, who called on the World Bank to convene a meeting of the international regional development banks to review their practices on the issue of guarantees and the broader question of sub-sovereign lending in order to address the Camdessus proposals. This meeting duly occurred in September 2003, and the report of the meeting is an important compendium of information about guarantees and an assessment of how much they are used, with proposals on how the demand for them could be increased (PricewaterhouseCoopers, 2003). In the meantime, a number of the IFIs have taken steps to increase their capacity to offer guarantees and re-examined the related issue of their ability to operate at a sub-sovereign level (see Chapter 2).

In July 2003 the World Bank and OECD sponsored a Conference in Vienna on the topic of “Private sector participation in municipal water services in Central and Eastern Europe and Central Asia”. The meeting brought together most of the private international water companies, large and small, together with development agencies and other interested parties. The revealing title of the Conference Report is “Facing a crisis of confidence in private sector participation in the water sector: measures to overcome obstacles to more effective PSP” (Box 1.3).

The Vienna Conference was significant in revealing the prevailing attitudes of private international water operators. The international development community, represented by the World Bank, OECD, EU and other agencies, confronted the leading private companies, challenged them to reveal their investment plans for an important region of the world, and invited them to discuss their experience and problems. The companies confided a high degree of nervousness and caution about the foreseeable future, and appealed for much greater support and comfort from the agencies.

Against this background, there is currently a high level of international interest in the greater use of guarantees to offset the risks encountered by lenders, equity investors and private operators in infrastructure investment in developing countries. The Camdessus Panel lent authoritative support to these instruments in the case of water, and similar arguments apply to their use for other types of infrastructure.

This study aims to place guarantees in a broader development context alongside conventional financing methods and other ways of mitigating risks, and seeks to provide a critical framework in which their role can be assessed in countries at different stages of financial and capital market development.

Box 1.3. The Vienna Conference

The main points from the Report are the following:

- The “easy” projects have been taken up and the private companies have tapped the obvious markets in this region.
- Outside the countries that are newly joining the EU, private companies appeal to international agencies for help in developing and opening up new markets. Even further east, reforms and changes will be needed in corporate culture and commercial behaviour, calling for long-term programmes from agencies.
- Despite its achievements in many areas, PSP has a negative image and lacks public acceptability.
- Private sector shareholders are much more risk averse than hitherto, and are compelling their companies to retreat from major overseas financial commitments.
- Companies need more help from agencies for mitigating risks not directly connected to operations, such as currency, regulation, payment, sub-sovereign, and affordability. There is little interest in fresh involvement in concessions, projects requiring major capital injections, or even leasing (*affermage*). Management contracts will find more favour in future.
- Agencies, for their part, have limited resources and cannot mitigate risks and provide institutional support across a broad front. Some selectivity is needed.
- Private operators should be used as instruments of change, and agencies such as the World Bank should be more involved as an honest broker in overcoming differences between companies and host governments.

Source: OECD/World Bank, 2003.

Notes

1. Risk has been defined as measurable uncertainty, the probability of an event actually happening. Where it is impossible, or implausible, to assign any probability to an event, normal insurance is not possible.
2. Hereafter, the term “guarantees” will be used to include insurance schemes also.
3. Keynes (1936) p. 62.
4. A long term security issued by a company yielding a fixed rate of interest and normally secured against the company’s assets.
5. Though some are used by agencies dedicated to promoting private investment, e.g. the IFC.
6. The leading sheep in a flock, with a bell on its neck.
7. The data record total investment in these projects, not just the contribution of the private partners. Definitions, and a full exposition of results, are contained in World Bank/PPIAF, 2003*a*.
8. A convention brokered by the Bank for International Settlements requiring banks to provide adequate capital coverage for their lending.

Chapter 2

The Case for Guarantees

The development of the international economy relies on an adequate movement of capital and managerial skills, interacting with the development of local capital markets and enterprise. Providing guarantees to mitigate investment risk is one of the ways in which international agencies can support these processes in developing countries. This chapter examines the arguments for the use of these guarantees, with specific reference to the finance of infrastructure projects and the development of local capital markets.

Although the argument is couched mainly in terms of risk reduction, guarantees have a broader attraction. For the issuing agency or government they leverage a multiple of the investment flows possible with a direct loan. From the point of view of the host country, they can be tailored to the precise needs of the beneficiary, and bring the latter into direct contact with capital markets – which should have learning value. (Magnusson, 1999).

Risk Sharing in Infrastructure

Infrastructure projects face risks common to all kinds of projects in their host countries, plus extra risks which are specific to the sector concerned, or which are greater than in other sectors. Most risks affect both local and international capital and enterprise, though not equally.

Generic Risks

The first class of risks apply to all types of investment, in all sectors.

Political risks include a spectrum of unforeseen political events which affect the viability of the project. First, there is the physical danger, damage and disruption from war and civil disturbance, terrorism, kidnapping of key staff, etc. A second type is nationalisation and expropriation without adequate compensation, and a third category includes restrictions on the conversion and transfer of foreign exchange to pay for imports, dividends or debt service. More generally, it includes any unforeseen action of government with a major bearing on the project concerned.

Credit risk relates to the possibility of late payment or default on a loan made, or on payment for goods and services supplied in the course of an investment or management contract.

Exchange rate risk arises where payments have to be made in a foreign currency out of proceeds arising in a different, local currency. The payments may be for goods and services, for debt service, or for payment of dividends. Infrastructure projects are especially liable to this risk because much or all of their revenues are normally in local currency (exceptions would be airports, telecommunications, trans-boundary sales of power and water, etc).

Commercial risks are of many kinds. Demand may be weaker than expected, prices may be less than foreseen, project completion may be delayed, capital and operating costs may exceed budget, interest rates may rise, etc. The main difference between commercial and non-commercial risks is that the former are considered inherent in all business dealings and the lenders and investors concerned are best placed to deal with them. Mitigation of commercial risk should rest primarily with lenders, operators or investors, initially at their own expense, and eventually in the expectation of recovering outlays through profits.

Specific and Disproportionate Risks

Unfavourable project profile. Much infrastructure is capital intensive, involving heavy initial costs, producing a stream of benefits stretching well into the future. There is a long payback period for this type of investment. This affects most hydro, water and wastewater projects, which are amongst the most capital-intensive forms of infrastructure. Since these investments are

of the “sunken” variety, and cannot easily be removed, financial returns are totally dependent on future revenues. The fact that these accrue over the long term places lenders and investors at the mercy of future unforeseeable events.

Low sector rate of return. Typical expected financial rates of return are 5-10 per cent in the water sector, 17-25 per cent in power (including both thermal and hydro) and 25-30 per cent in telecommunications¹. Returns in water are depressed by the inability of utilities to charge economic levels of tariffs owing to political interference² and inhibitions due to the “social” status of water services. This makes it difficult, for instance, to disconnect consumers who fall behind in payment. It is not usually possible to compensate for the higher perceived risk of water projects through higher *ex ante* rates of return. Low tariffs remove a possible cushion to offset other kinds of risk.

Sub-sovereign risk. In recent decades, there has been a widespread devolution of responsibility for water services from central to local governments, and to utilities and agencies enjoying a degree of operational autonomy. However, there has rarely been a commensurate transfer of financial powers or managerial skills, and entities with the new responsibilities have lacked the full freedom to function effectively, especially in the financial domain. Lenders, investors and operators deal increasingly with municipal and other local level agencies, and are seeking ways of dispensing with full sovereign guarantees for their financial exposure. The result, however, is that they are having to deal with inexperienced and under-funded counterparts, and are exposing themselves to the various kinds of sub-sovereign risk. This point is taken up below.

Contractual and regulatory risk. Sectors supplying a public service with local monopoly features, such as water and power, are usually closely regulated to safeguard the public interest. Regulation can be either by a specialised public agency or through a contract specifying the duties and rights of the operator/investor, which may include the right of appeal to an arbitrator. Some contracts, such as BOTs, depend on “take or pay” agreements with a public sector off taker. Each of these types of contract or regulation is liable to political influence, to the potential detriment of the investor. Many investors enter contracts with an imperfect knowledge of local conditions, their clientele or the state of the assets they are working with (e.g. underground networks). However, it may be difficult to rectify this ignorance (a case of “asymmetric information”) through contract renegotiation. From the moment when the main investment is completed, investors and operators are at the mercy of their hosts, and depend thereafter on the authority of the regulator, the robustness of their contract, and whatever powers of independent arbitration are stipulated in their contract.

The Sub-sovereign Issue

Guarantees have acquired added importance from the growth of interest in financing entities below sovereign levels of government, who are unable to avail themselves of a central government (sovereign) guarantee. As noted above, for many municipal services and others, the relevant operational mode is below central government level, and the responsible entity needs sufficient financial autonomy, resources and access to funding in order to perform its functions efficiently. International agencies, especially the IFIs, are currently reappraising their sub-sovereign lending policies and practices with a view to increasing their lending capacity at this level (PriceWaterhouseCoopers, 2003). The offer of guarantees to sub-sovereign bodies is an important part of this armoury.

Types of Guarantees

The various guarantees available are described below under four categories, those dealing respectively with political, regulatory and contractual, credit, and foreign exchange risks.

Political Risk

Political risk instruments (PRIs) date from the 1960s and are now thoroughly established and widely used in financial markets. They cover war and civil disturbance, expropriation and confiscation, and currency convertibility and transferability. In recent years, some institutions have added terrorism, which is not generally provided by private insurers. The largest public schemes are operated by bilateral agencies with a mission to promote national exports and overseas investment, such as OPIC, ExIm Bank, ECGD, Hermes, COFACE, etc. These commercially motivated schemes are excluded from the scope of this study.

A number of multilateral and bilateral agencies offer PRIs as part of more comprehensive cover, for example with credit guarantees. Some IFIs also offer PRIs in connection with loans they make. In the period 2001-2003, IFIs issued 46 guarantees for infrastructure projects against traditional political risk, to a value of over \$2 billion – 39 of these guarantees were by MIGA (see below).

The best-known multilateral standalone PRI is that of the Multilateral Investment Guarantee Agency (MIGA), part of the World Bank Group³. MIGA operates without the need for a sovereign guarantee and has cover available for equity investment, shareholder loans and shareholder loan guarantees. In principle, MIGA's cover is limited to *new* cross-border investment (equity or loans exceeding three years' maturity) but investment in existing projects for the expansion, modernisation or financial restructuring of existing projects is also eligible. Acquisitions involving the privatisation of state-owned enterprises may also be covered. Although the main target group for this policy is the cross-border investor, investments made by nationals of the host country can also be eligible. State-owned corporations can also be covered if they operate on a commercial basis.

Cover is available up to 90 per cent for equity investments, and up to 95 per cent for debt, with terms up to 15 years, occasionally extended to 20. The limit for cover is normally \$200 million, but more can be arranged through syndication. The pricing of the policy is fixed on the basis of both country and project risk, with premium rates averaging 2-3 per cent p.a. for multi-risk cover. Projects are expected to be financially and economically viable, environmentally sound and consistent with the labour standards and other development objectives of the host country. MIGA requires Host Country Approval before issuing a contract.

Although MIGA has issued a total of over \$11 billion of guarantees for more than 600 projects, its exposure to the water sector is limited to six projects, five of which were run-of-the-river hydropower schemes and the sixth the Guayaquil water concession (Box 2.1), though a number of other projects are in the pipeline.

In the mid-1990s, private insurers entered the PRI market in response to the demand from banks and investors in large PPI infrastructure transactions that public agencies were unable to satisfy. The major private insurers are American International Group, Sovereign Risk Ltd, Zurich Emerging Market Solutions and several Lloyds' syndicates. Private insurers now account for \$35-40 billion of PRI cover, out of a total of c. \$80 billion. Compared with those of official and development agencies, private sector policies tend to be for shorter terms and more flexibly tailored to specific risk. Premiums are sensitive to market conditions, though generally higher than those of official insurers. This is a reflection of the ability of private insurers to insure larger amounts, partly because of their access to reinsurance, plus the untied nature of their cover, their speed of processing, and the implicit subsidy in many public schemes. Some private insurers do not offer PRI because of what they believe is uneconomic competition from official bodies (Jordan, 2004).

Box 2.1. Political Risk Cover for a Water Concession in Guayaquil

In 2001 the Ecuadorian coastal city of Guayaquil, a conurbation of around 2 million people, awarded a 30-year concession to International Water Services (Guayaquil) BV of the Netherlands for the expansion and rehabilitation of its municipal water services.

The decision was taken as a solution to the serious worsening of the level of service and the state of infrastructure after rapid population growth and under-investment over many years. A high proportion of the population in the poorer districts had no access to safe water or adequate sanitation, and the service to connected households was poor and unreliable. Only 50 per cent of billings were actually collected.

MIGA provided an \$18 million policy for political risk insurance covering expropriation, war and civil disturbance. It explicitly included the wrongful call of the performance bond, which the company was obliged to deposit to guarantee its implementation of the concession contract. This contract links tariff increases to improvements in the quality of water and service delivery, and specified increases in the number of water and sewerage connections. Non-compliance with these performance conditions could trigger the call of the performance bond at any time.

Source: MIGA.

Increasing co-operation between public and private insurers in recent years has improved the availability of PRI since private insurers benefit from sharing risks with public agencies enjoying “preferred creditor status”. Generally speaking, private insurers have the advantage in terms of the range of risks covered, flexibility of product design, speed of processing and expertise in risk management, whereas MIGA scores in its tenor (length) of coverage, track record, and relationships with host governments. Private insurers tend to have a higher proportion of their exposure in high-risk countries, such as in Latin America (Jordan, 2004).

A number of multilateral agencies also offer *Preferred Creditor Status* (Box 2.2) to lenders participating in their loan syndications. The B Loan system gives participating banks Preferred Creditor Status matching that of the A loans extended by the multilateral agency. This so-called *halo effect* gives participating banks the comfort of knowing that they have the full weight of multilateral organisations behind them in the event of debt repayment difficulties⁴.

Box 2.2. Preferred Creditor Status and Participations

Multilateral development institutions, such as the World Bank, IFC, and the leading regional development banks such as AsDB, AfDB and IADB, enjoy *de facto* preferred creditor status. This means:

- Governments having a treaty relationship with the respective institution grant the latter's loans preferential access to foreign exchange in the event of a foreign exchange crisis.
- These loans are exempt from automatic country risk provisioning applied by banking regulators.
- Interest on the loans is exempt from tax, including withholding tax.
- The loans are excluded from general country debt rescheduling as part of the London Club, and are not subjected to mandatory new money obligations under a general country debt rescheduling.

A multinational agency making a loan can open up *participation* in that loan to other banks, in a *syndication*. A good example is IFC, which pioneered the use of B Loans in the 1970s. Loans made on its own account are termed A Loans, while B Loans are those made on the account of banks taking part in the syndication. B Loans have the same status as A Loans in the following respects:

- IFC is the "lender of record", administers the entire loan and collects all repayments from the borrower.
- IFC is committed to distribute payments *pro rata* among itself and the participating banks
- IFC cannot be repaid in full unless and until all participants have been paid in full.
- Any default to a participant is regarded as a default to IFC.

Other agencies have a similar system, with slight variations in the terminology of syndicated loans.

Sources: IFC Syndications (undated), a regular publication; World Bank (2002) Frankfurt presentation; www.ifc.org/syndications.

Prior to the Asian financial crisis in 1998, the rate of default and arrears (*non-performance*) on the IFC's B Loan portfolio was below 1 per cent, though this had risen to 17 per cent by June 2003. The system was tested in Russia during the 1998 moratorium on external debt repayments, and preferred creditor status was upheld for B Loan holders, where borrowers had local currency available. In the same year, Pakistan stopped repaying foreign debt

and accumulated arrears to the World Bank Group. The Government confirmed the preferred creditor status of A and B Loans but indicated that it had no reserves available to allow even preferred creditors to be serviced.

As the Pakistan example indicates, and as the more recent experience of Argentina confirms, B Loan status is not a cast-iron guarantee of repayment. In the last resort, B Loans depend on the host borrowing country having sufficient foreign exchange available for debt servicing for preferred creditors. The B Loan system is complementary to PRI rather than a substitute for it, covers lenders rather than equity investors, and is mainly relevant to middle-income countries (Jordan, 2004).

B Loans offer an alternative to political risk insurance policies covering transfer and convertibility (T & C) risk, and has several advantages over PRI. B Loan enhancement covers all debt service, whereas PRI may only cover part. Multilateral lenders tend to be more concerned than insurers about the commercial success of borrowers, and take all steps within their powers to maintain their creditworthiness. Where the borrower has enough local currency, the willingness and ability to supply foreign exchange is that of the borrower's government, whereas with PRI payment rests with the insurer, whose willingness and ability to pay in a timely fashion is variable (especially in the case of "multiline"⁵ insurers). PRI generally involves complex documentation and may involve lengthy legal argument about interpretation of the fine print in policies.

Regulatory and Contractual Risk

As offered by the IFIs, cover includes breach of contract, changes in law, licence requirements, approval and consents, obstruction in the process of arbitration, arbitral award following a covered default, and non-payment of a termination amount. This product started to be offered from the early 1990s with the growth of projects for private participation in infrastructure. The cover is more difficult to arrange than PRI since it relies on the legalities of specific transactions and the undertakings given by the government about regulation. The events that would trigger a call of the guarantee must be clearly defined, and the remedies stipulated in the agreement must be exhausted before payment is made. In short, cover is very project-specific, transaction costs are very high, and the processes that would trigger a claim can be protracted (hence some agencies provide interim payments against a legitimate claim).

The majority of IFIs now offer some form of cover against these risks. The World Bank's Partial Risk Guarantee (PRG) is the most comprehensive, though breach of contract cover is standard, and MIGA recently introduced a specific Breach of Contract guarantee. In practice, breach of contract cover can be extended to a range of other related risks, including devaluation in the event that tariff escalation clauses are part of the contract. Only MIGA and the Islamic Development Bank cover equity as well as debt, and in both cases a sovereign counter-guarantee is unnecessary.

Since the early 1990s, the World Bank's PRG covers commercial loans to infrastructure projects against the specific risk that the host government may fail to carry out its contractual undertakings. The host government reimburses any payments under these policies. PRGs have, however, been little used to date. They are available in countries eligible for financing on IBRD terms, which excludes low-income countries. They are also limited to loans, and not equity (though unlike other guarantees that only cover the lender, PRGs effectively give comfort to equity investors since they dissuade host governments from being in breach of contract). For the host government, guarantees count against the country's borrowing limits, and are less interesting than a direct loan. In addition, many commercial lenders view IFI procedures as slow and bureaucratic (Jordan, 2004).

In the period 2001-2003, IFIs covered 14 infrastructure projects for this type of risk, to a value of \$976 million. Most of these were by MIGA.

Credit Risk

Partial Credit Guarantees (PCGs) are the most common form of cover for credit risk. PCGs limit cover to a percentage of the total amount borrowed. With that proviso, they can cover against non-payment to that portion of debt service falling beyond the normal tenor of loans available from commercial lenders, or can underwrite a portion of debt service payments due at any time. In effect, they can stretch loan maturities available for infrastructure investments with a long gestation and payback period, and/or can make the credit available on terms that are more favourable. PCGs can cover all kinds of event causing non-payment, including commercial risk. In that sense, they are comprehensive.

IFC's Partial Credit Guarantee was introduced in 1999 and is one of the best-known instruments of this kind. It is offered to clients for enhancing the credit status of borrowings through bonds or loans,

and covers creditors irrespective of the cause of default. The guaranteed amount is capped at an agreed-upon amount, such as a proportion of the initial principal, or one year of debt service. The guaranteed amount may vary over the life of the loan (e.g. it may be related to the outstanding amount of principal at any one time). Borrowers facing temporary cash flow problems may draw proactively on the guarantee to head off a default, and reimburse IFC within a given period without serious penalty.

PCGs are intended to improve the access of companies and sub-sovereign entities to funding sources through direct credit enhancement. In most markets, loan tenors are very short, and the PCG can lengthen these, to suit the borrower. Multilaterals such as IFC apply the same credit and due diligence procedures, including supervision, for guarantee proposals as they would for direct loans, which provides comfort for lenders and investors. The creation of high-quality assets with long tenors helps to create benchmarks in domestic capital markets that assist other borrowers to secure long-term borrowing.

The difference that PCGs offered by the IFIs can make is illustrated in Box 2.3, most of which relate to foreign exchange loans.

Notwithstanding these potential benefits, the overall market uptake for multilateral PCGs has been low. In 2001-2003, only six credit guarantees were issued for infrastructure, to a total value of \$800 million. Two of the four IFC projects are in the water sector.

It is less common for IFIs to produce the same effect for local currency operations because of the need for them to enter into swap arrangements, which are relatively expensive. In addition, the credit enhancement provided by an IFI, which is reflected in the price of the guarantee, is in a sense “excessive” since domestic issues normally have a lower rating scale and credit status. Despite this, there are examples of international institutions using PCGs to enhance domestic currency borrowings (Box 2.4).

Since the 1970s, private insurance companies have also been active in the credit risk market and now offer serious competition to the agencies. The so-called monoline insurance companies offer integrated risk management products, with credit risk included. However, monoline companies require an investment-grade rating before the guarantee, whereas multiline companies can accept lower rated transactions, and prefer high non-investment grade transactions before the guarantee (Kotecha, 2004).

Box 2.3. Impact of Partial Credit Guarantees on Lending Terms

	Without guarantee	With guarantee
Colombia:		
Interest	6.5%	5%
maturity	5 years	10 years
Philippines		
Interest	3%	2.5%
maturity	7 years	15 years
Uganda		
Interest	8%	3.1%
maturity	n.a.	16 years
Bangladesh		
Interest	3%	2%
maturity	1 year	13 years
Côte d'Ivoire		
Interest	3%	2.75%
maturity	1 year	12 years
China: maturity	7 yr	15 yr
Pakistan: maturity	3 yr	15 yr
Jordan: maturity	2 yr	7 yr
Lebanon: maturity	5 yr	10 yr
Morocco: maturity	5 yr	15 yr
Russia and Ukraine	7 yr	10 yr
Thailand: maturity	n.a.	10 yr
Argentina: maturity	3 yr	5 yr

Sources: World Bank presentations and internal data.
n.a. = implies loan not available without guarantee.

Box 2.4. Partial Credit Guarantee for the City of Johannesburg

IFC is providing a PCG for the rand equivalent of \$30.4 million for a 12-year domestic bond issue by the City of Johannesburg. The value of the whole bond issue is \$150 million. The issue is also supported by a local currency PCG extended by the Development Bank of Southern Africa which raises the total PCG to 40 per cent of the total issue.

The bond's proceeds will be used to fund essential investment in infrastructure, especially water, electricity and roads. Part of the bond proceeds will also be used to restructure the city's existing debt to improve its debt profile.

The joint PCGs will help the city to diversify its investor base by upgrading the bond's local rating by three notches in the Fitch scale, from A- to AA-.

Source: IFC.

Foreign Exchange Risk and Development of Local Capital Markets

As a realistic and affordable commercial tool, foreign exchange risk cover is not available from either private insurers or official agencies. In practice, other ways of avoiding or reducing devaluation risk have to be used. Broadly, there are five approaches (Matsukawa *et al.*, 2002; Haddon, 2004): the use of local currency finance, currency hedging, government exchange rate guarantees, indexing tariffs to foreign currency and devaluation liquidity backstop schemes.

Local Currency Financing

The most satisfactory long-term solution to forex risk is the greater use of local sources of finance, denominated in the same local currency as the source of project revenues. This depends on such finance being available on interest and maturity terms which, when devaluation risk is factored in, are superior to those available in foreign exchange. Development agencies have started to develop new products for guaranteeing debt raised in local currency⁶. This approach has great potential to mobilise local savings for infrastructure finance where local banks and institutional funds are liquid, are seeking safe outlets for their deposits, but are prevented by law from investing in paper of sub-investment grade.

In some recent cases, an international PCG has raised the status of the security to investment grade, thus mobilising a new stratum of local savings for infrastructure finance. It is worth recalling that the involvement of a reputable international operator in a project should also enhance access to local funding, both because of the presumed improvements to the project's efficiency and financial standing, and because of the *reputational risk* borne by the operator.

So far, this technique has been limited to Upper Middle Income developing countries or others with sufficiently well developed financial institutions and efficient capital markets. A number of cases have been in Latin America where these preconditions are present, and, in particular, where sizeable pension funds exist (Vives, 1999). The Tlalnepantla project in Mexico, discussed in more detail later in Box 4.2, is a case in point. Another is the Costanera Norte toll road in Chile, where the project raised \$260 million with a 100 per cent guarantee of interest and principal from the IADB, 85 per cent of which was passed on to a monoline insurer. The guarantee lifted the national scale rating of the security to the point where it was attractive to local institutional investors with little experience of evaluating project loans, and who were legally constrained in taking up lower-rated securities (Haddon, 2004).

The local currency guarantee is a promising instrument, but has some limitations:

- i) The guarantee covers credit but not inflation risk. This can be met by the use of floating rate debt, or by loans indexed to local inflation (commonly used in Latin America), backed by an off take contract or concession agreement that allows the borrower to increase prices in line with local inflation.
- ii) It does not cover performance risk of the host government, where the solvency of the deal depends on measures agreed with the government. Other kinds of insurance (e.g. PRGs) may be available to mitigate this risk.
- iii) Long-term local currency borrowings are often more expensive than euro or dollar loans, even with a guarantee.
- iv) Many countries do not have the financial resources and institutions able to lend on the scale and maturities required. Local commercial banks may be unwilling or unable to use their short-term deposits to make long-term loans, even with a local currency guarantee (Haddon, 2004). This underscores the need for local capital market development if local currency guarantees are to be effective.

Some agencies are devising schemes specifically with Low Income countries in mind. A newly formed fund, GuarantCo, an initiative of several donor agencies in the Private Infrastructure Development Group, also aims to guarantee local currency finance for infrastructure by local institutional investors and others (Box 2.5). From the donor agency's perspective, this kind of guarantee fund has the additional benefit of being accountable as official development assistance within the DAC's conventions on aid statistics.

Box 2.5. GuarantCo

GuarantCo, the Local Currency Guarantee Facility for Infrastructure, is being launched by the UK's DFID, SIDA and other partners in the PIDG with the aim of mitigating risks in local currency financing of infrastructure by local institutional investors and others. It will have a particular focus on sub-Saharan Africa, and will operate in poorer countries, as defined by the DAC.

GuarantCo was established as a limited liability company in 2003, with the PIDG Trust as sole shareholder. Its purpose is to provide credit enhancement of bonds and other commercial paper issued by PSP infrastructure projects and certain municipal bonds. It will counter-guarantee the partial guarantees of local banks made to bonds of infrastructure projects. Investors will be left with some residual risk, and the counter-guarantees offered to local banks will not cover their full exposure.

Amongst projects under active examination are credit enhancement of a municipal bond issue, refinancing of an electric power utility, guarantee of a mortgage portfolio, credit enhancement of a bond issue for a toll road, and guarantees for the commercialisation of a water company. The Facility's maximum equity is expected to be \$100 million, when it is fully operational, with a leverage of three times this amount.

Source: DFID.

USAID's Development Credit Agency aims to mobilise local capital through a system of risk-sharing through its Partial Loan Guarantees. Although the precise modalities vary from case to case, the general theme is to use initial injections of grant/equity to create revolving funds, in combination with loan guarantees of 50 per cent to mobilise local capital through loans or bonds. The model follows that used successfully in the United States whereby the Environmental Protection Agency provides grants ("seed money") to states for the creation of revolving loan funds to finance local water infrastructure. These funds are leveraged from local borrowing, against the security of the initial grant, and replenished from loan repayments (Box 2.6).

Box 2.6. US Clean Water State Revolving Funds

After the Water Act of 1972, which laid down compulsory federal standards for wastewater treatment, US states were able to finance new wastewater treatment plants with 80 per cent federal grants, with the balance from state governments. But with the passage of the Clean Water Act of 1987 and the Safe Drinking Water Act of 1996 the approach to financing changed, and a more sustainable model found favour.

Under current practice, the federal government provides grants to states for funding municipalities building the wastewater plants, with the requirement that the money should create a financially sustainable programme. All states have created revolving loan funds, of various types, with the common factor of using federal grants and state contributions as initial capitalisation, and using this reserve fund as security for commercial bank borrowing. The funds are replenished from loan repayments and interest earned on balances.

Each loan made for individual investment is obliged to be repaid, from a pledge of user fees, tax revenues, sale of securities, or other means. The existence of such “credit support mechanisms” enables the revolving funds to borrow (or issue bonds) at favourable rates without a sovereign guarantee and to provide interest subsidies to deserving projects. The collection of individual loans forms a “loan pool” with a higher credit rating than those of the individual borrowers.

It is a condition of federal finance that the states should rigorously protect the reserve fund from appropriation for other uses. This is a crucial factor in maintaining the scheme in good credit standing with bond markets and rating agencies.

Source: Baker (2001).

This approach has been the basis of a number of USAID programmes in developing countries (Box 2.7), in a variety of sectors – agriculture, water, housing, energy, health, small enterprise development and microfinance, etc. In each case, the DCA is able to provide a high leverage for the cost falling on its budget. In the water sector the model seems to work best where there is good repayment capacity on the part of consumers, and where there is a reasonably good local financial infrastructure with potential loanable funds. These conditions are typically present in urban areas of a certain critical size, and in countries that have progressed beyond the earliest stages of development.

Box 2.7. US Development Credit Agency Programmes

In *Tamil Nadu, India*, the investment programmes for water supply and sanitation of 14 Urban Local Bodies have been combined in a Water and Sanitation Pooled Fund, which has been given credit enhancement through a 50 per cent DCA guarantee. The Fund has issued 15 year bonds totalling \$7 million with a 9.2 per cent coupon, initially subscribed by five leading financial institutions, and subsequently disposed of at a premium in the secondary market. The majority of the investment is funded from borrowing, and will provide for the upgrading of water supply to very poor urban communities.

In *South Africa* DCA has a programme (with DFID and a local NGO) to upgrade water and sanitation services to one million poor urban people in five municipalities. Total investment is over \$17 million, most of which is funded from local loans receiving credit enhancement from DCA.

In nine centres in *South Sinai, Egypt*, DCA has risk-sharing arrangements to encourage local currency loans for private sector participation in outsourcing operation and maintenance of water systems under performance-based contracts.

Sources: DCA information briefings and presentations.

Guarantees are also being used to promote local currency microfinance and student loan schemes (Box 2.8).

Box 2.8. Microfinance and Student Loan Schemes in Kenya and South Africa

In *Kenya*, the AFD has provided a credit guarantee to FAULU, a local microfinance company whose main shareholder is an American charity. FAULU has been operating since 1991 and provides credit to groups and associations for a range of productive activities. Following the change of government in 2003 there has been a reversal of capital flight and a modest revival in business expectations. Banks are liquid and interest rates have fallen. The government is committed to promote small and medium scale enterprises, recognising the preponderance of the informal sector in the economy. However, commercial banks do not lend to microfinance institutions.

There is a high level of unsatisfied demand for microfinance amongst small and medium sized businesses, and FAULU is well placed in the market. It has a sound credit methodology and over 10 years has steadily grown and improved its balance sheet and level of self-financing. Its net profit ratio is currently 36 per cent.

FAULU is issuing KSh. 500 million (c. €8 million) of five-year bonds in the local market with an AFD guarantee for 75 per cent of principal and interest.

In *South Africa* AFD is guaranteeing a loan to Edu-Loan, a private microfinance institution specialising in providing educational and training loans to the lowest income-earners. Edu-Loan was set up in 1996 and since then has financed training, mainly correspondence courses, for more than 200 000 students, usually wage earners. Its typical loan is €300, equivalent to one month's salary. Edu-Loan is able to charge interest at below-market levels, thanks to agreements with the universities to reduce enrolment fees for financially solvent students. Edu-Loan is able to secure loan repayments through indirect access to the civil service wage system, an arrangement now being extended to its private sector clients.

Edu-Loan has a short term financing facility from a local commercial bank and long term finance equivalent to €3.6 million from DEG and IFC.

AFD has arranged a guarantee payable on first demand covering a rand loan to Edu-Loan from a South African bank. The loan consists of two elements – a short term line of credit for working capital, and a longer term credit for strategic expansion, with a combined amount equivalent to €7.5 million.

Source: AFD.

Several bilateral agencies, including those quoted so far, now operate local currency guarantee schemes in which, because of their remit, they have greater operational freedom. There is also an example (Box 2.9.) of guarantees being used to foster a *regional* bond market which is an intermediate form between local and “hard currency” issues.

Box 2.9. The West Africa Economic and Monetary Union (WAEMU)

The eight WAEMU countries (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) share the same currency (the CFA franc, anchored to the euro at a fixed rate of 1 euro = 656 CFA francs) and the same central bank (Banque Centrale des États de l'Afrique de l'Ouest – BCEAO). Created in 1996, the WAEMU financial market is a significant example of a regional integration strategy based on co-ordination of economic and monetary policies.

The regional bond market was created five years ago, and has grown in strength, with 50 emissions so far made for an amount of 400 billion FCFA (€610 million) with an average tenor of five years. Demand exceeds market capacity: bank liquidity is estimated at around 800 billions FCFA (€1.2 billion) in the region. The bond market is one of the few possibilities to gain access to long-term finance in the region.

The Agence Française de Développement (AFD) is promoting the mobilisation of resources on the local financial market by providing its guarantee to local issuers. AFD has recently helped the National Bank of Mali for the Development of Agriculture (BNDA) to undertake its first bond emission for an amount of 3.5 billion FCFA (€5.3 million). Hence BNDA is decreasing its reliance on concessional finance in euros by tapping the local financial market, while mitigating foreign exchange risk.

The WAEMU financial market has a potential of around 300 billion FCFA (€457 million) of bond emissions per year. However, there are major impediments to the development of the bond market: there is no benchmark and no rating agency specialised in this market, guarantees are compulsory for non-sovereign issuers, their cost is high (between 9 and 10 per cent) compared to euros, and tenor is limited. The World Bank, in partnership with AFD and the Canadian International Development Agency (CIDA) has recently launched a project aimed at developing this capital market and facilitating the mobilisation of local currency for infrastructure projects.

Source: AFD.

Currency Hedging

The risk of future devaluation could be eliminated by opening forward agreements to purchase, in local currency for future delivery, the amount of foreign exchange needed to meet future payment commitments. The local currency cost of these contracts would be determined by the forward exchange rates quoted at the closure of the investment transaction. Obviously they would be less attractive the greater the risk of future devaluation was perceived to be. As a practical matter, only a limited number of countries, and practically no low-income countries apart from India, have markets for foreign exchange futures of the duration needed by infrastructure investors. In practice, hedging is not used in the finance of infrastructure projects in developing countries.

Government Exchange Rate Guarantees

Host governments may take on the exchange risk of a loan or investment. This may be a by-product of a fixed-exchange rate regime, which history shows may not survive serious macroeconomic stress. Or the guarantee may apply only to foreign lenders and equity investors: in the 1950s, for instance, Brazil permitted remittances and debt service to take place at the same exchange rate at which the capital originally entered⁷.

A further variant is to limit the guarantee to specific projects. The best-known example of this is the foreign exchange risk insurance scheme (FERIS) used by Pakistan in the mid-1990s for HUBCO, the country's first Independent Power Provider. In its contract, HUBCO was able to pass devaluation costs on to the off taker, the official agency WAPDA (the Water and Power Development Agency). The State Bank of Pakistan, and ultimately the Government, guaranteed payment to HUBCO of foreign exchange at a rate fixed at project completion in 1997. Pakistan's currency crisis in 1997 exposed the high cost of this and similar arrangements⁸, and the scheme was discontinued.

For investors who borrow locally, the host government or its lending agencies may also offer loans denominated in local currency; where these are used to buy imports they enable the investor to avoid taking on the foreign exchange risk of a foreign loan.

Indexing Tariffs

A power or water tariff may be indexed to a foreign currency so that over time it adjusts to keep a constant level relative to the currency concerned. Carried to its logical conclusion, the local tariff may actually be expressed in dollars, or some other foreign currency. Indexing tariffs to the cost of a major tradable input, such as energy, will have a similar effect. Indexation clauses do not fully protect against devaluation where there are delays in adjustment or minimum thresholds of cost increase to trigger the adjustment. Also, they tend to break down where the devaluations are so large that the implied increase in domestic tariffs is implausible.

Alternatively, the contract could provide for the creation of reserve accounts from tariff income as a contingency against devaluation shocks, or to specify tariff review procedures if currency movements exceeded an agreed range.

Liquidity Facilities

Another approach is to provide liquidity to projects that cannot meet foreign currency obligations owing to a sudden and large devaluation. The funds would be repaid over time as tariffs rose at an affordable rate. The Camdessus Panel proposed a variant of this for further study and piloting (Box 2.10).

Box 2.10. The Devaluation Liquidity Backstopping Facility

The Camdessus Panel proposed a scheme that would apply to projects operated by either private or public sector sponsors, where the water service provided was subject to targets and regulation set by governments, and where the provider had no other means of mitigating devaluation, nor could its project partners avoid it.

The DLBF would be a contingent facility provided by an international public body with a first class financial standing, able to carry the financial burden from devaluation up to the end of the period of revenue recovery. The international body would guarantee the foreign loans involved and finance the additional debt service entailed by devaluation. The guarantee would be counter-guaranteed by the host government, and disbursements on it would create sovereign debt. The national government would recover its outlays by levying an “affordable” water surcharge, collected through the usual billing entity over an appropriate period of time.

At the time the foreign loan was contracted, an initial base case financial model would be produced, predicting a specific proportion of debt service to revenues under “normal” operating conditions. This percentage would translate into a nominal amount of local currency which, when divided by the payment due in foreign currency, gives the “affordable” exchange rate. This rate is the threshold above which the DLBF would intervene.

Amongst other features, the project would pay annual premiums to the Facility, a minimum level of devaluation would be borne by the project, and any positive post-devaluation exchange rate changes would reduce the compensation amounts.

Source: Winpenny (2003).

To date, the only example of this kind of scheme in commercial use is the facility created by the US OPIC in support of the AES Tiete power project in Brazil (Box 2.11).

Box 2.11. OPIC's Exchange Rate Liquidity Facility for AES Tiete Project

AES Tiete is a complex hydropower scheme in São Paulo, Brazil, privatised in 1999, which sells power to the State at an inflation-indexed price. The owners of the company issued fixed interest securities to a value of \$300 million protected by devaluation coverage offered by OPIC, in the form of a \$30 million stand-by credit facility.

Payment is triggered when the real exchange rate falls below the floor values fixed at the time of the deal, and if the project is unable to meet its scheduled debt service payments. Currency risk is isolated from operational risks. The facility is revolving, in the sense that advances are repaid, with interest, when the project has a positive cash flow after servicing senior debt, for example after a subsequent appreciation of the real exchange rate.

The use of this Facility enabled the securities to achieve an investment-grade rating at the time of their issue (though they have subsequently been downgraded, owing mainly to local market problems and the status of the power off taker). The scheme relies on several key factors for its viability: the existence of a reliable and transparent measure of local inflation; a foreign exchange market responsive to market forces; a convertible currency that is initially not substantially overvalued; and a risk that is relatively modest and quantifiable on historical evidence. *Ipsa facto* this limits its potential application to a few emerging markets.

Sources: OPIC presentations; Matsukawa *et al.*, 2003.

Matching Risks with Instruments – A Summary

Many instruments cover more than one type of risk, and each agency's product is differentiated from that of others. With this caveat, the broad picture is presented in Figure 2.1.

Figure 2.1. **Infrastructure risks and Relevant Risk Mitigation Instruments**

Type of risk	Available RMI	Examples
Political, foreign exchange availability	Political risk cover - either specific, part of comprehensive cover, or in a credit guarantee; preferred creditor status	MIGA political risk cover; participations (e.g. B loans)
Credit	Partial credit guarantees (PCGs)	IFC Partial Credit Guarantees; USAID DCA Partial Loan Guarantees
Devaluation	None as such. Local currency guarantees and devaluation liquidity schemes are relevant	IFC local currency Partial Credit Guarantee; OPIC Foreign Exchange Liquidity Facility; GuarantCo
Commercial	None specifically; but PCGs include this risk amongst others	
Project profile	PCGs can lengthen loan tenors to match cash flows	PCGs
Rate of return	Breach of contract cover can protect tariff covenants; devaluation liquidity schemes protect cash flow following devaluations	MIGA Breach of Contract cover
Sub-sovereign	Certain RMIs can be offered without a sovereign counter-guarantee (SG), others need SG. Relevant RMI depends on the type of risk to be covered	These don't need SG; IFC PCG MIGA PRI Private sector guarantees from IADB, AsDB, AfDB, etc. These do need SG: IBRD PRG IBRD PCG Public sector lending of IADB, AsDB.
Contractual and regulatory	Breach of contract cover	World Bank Partial Risk Guarantee; MIGA Breach of Contract cover

The Main Sources of Development Guarantees in Perspective

It is difficult to obtain a comprehensive and accurate portrayal of the value of guarantees in comparison with conventional aid instruments. Data on guarantees offered by IFIs have been recently collated in a one-off exercise co-ordinated by the World Bank, which is drawn on below (PricewaterhouseCoopers, 2003). However, most bilateral agency guarantees are not currently reported to the Development Assistance Committee of the OECD and are not included in the totals of overseas development assistance (ODA) used for comparing countries' performances. There are methodological problems to be resolved and statistical reporting conventions to be established before this becomes possible (DAC, 2004).

With these disclaimers, it is clear that the value of guarantees issued in recent years has been small in relation to conventional overseas development finance and private flows. Table 2.1 summarises the main categories of conventional resource flows to developing countries.

During the period 2001-mid-2003, the major IFIs issued 124 guarantees in all sectors, with a total face value of c. \$5.0 billion. Fifty-two of these, 36 per cent by value, were for infrastructure. The largest supplier is MIGA, which over its life has issued 680 policies (by mid-2003), mostly for political risk, in 85 developing countries, to a total value of over \$11 billion, and with a current outstanding value of c. \$5.1 billion. Issues of the IFC's Partial Credit Guarantee, introduced in 1998, totalled \$1.53 billion between 2000 and mid-2004⁹. The comparative data for the main IFIs are shown in Table 2.2. This volume of guarantees is equivalent to an annual level of c. \$2 billion.

Table 2.2 does not include guarantees issued by EIB and EBRD, for which data are not available on the same basis. EIB has an extensive guarantee programme for members of the European Union, and can also offer guarantees for its lending to Africa, Caribbean and Pacific countries under its mandate from the European Commission, and specifically through the Cotonou Investment Facility. An example is given in Box 2.12.

EBRD's extensive sub-sovereign lending programme contains both explicit guarantees and the use of Municipal Support Agreements (MSAs) which aim to provide comfort through other means. MSAs are discussed in Chapter 4. As an example of a stand-alone guarantee in the agro-industrial sector, EBRD is extending a 7.5 million euros partial credit guarantee for an Uzbek commercial bank (UzJilSberbank) to lend to Nestlé Uzbekistan to extend its purchases of milk and milk products from local farmers¹⁰.

Table 2.1. Total Net Resource Flows from DAC Member Countries and Multilateral Agencies to Aid Recipients:
\$ billion, current values. Annual average 2000-2002

Official Development Finance	
Total	65.7
Bilateral	42.3
Multilateral	23.4
Export credits	3.0
Direct investment	120.9
International bank lending	(-14.0)
Bond purchases	15.6
Other private flows (inc. equity investment)	(-17.5) 10.7
Grants by NGOs	

Source: DAC (2004).

Table 2.2. Guarantees Issued by Main IFIs, Jan 2001-June 2003

	Number	Value \$ million (rounded)
AfDB	1	14
AsDB	3	560
IADB	1	150
IsDB	1	6
IBRD	4	451
IFC	19	424
MIGA	95	3 406
Total above	124	5 011

Source: PricewaterhouseCoopers (2003).

Box 2.12. EIB Guarantee for West African Development Bank (BOAD)

BOAD operates in the industrial, agribusiness, mining, tourism and service sectors in its regional member countries. In July 2004 EIB concluded a support arrangement for BOAD consisting of a 25 million euros global loan, a 25 million euros guarantee facility, and a 4.5 million euros participation in a capital increase. Its aim was to underpin the bank's operations in support of the private sector, to stimulate a wider range of financial instruments, and develop the regional capital market.

The guarantee facility consists of a partial guarantee of BOAD's loans to enterprises and a partial counter-guarantee for BOAD's own guarantees on an enterprise's bond issues or other securities.

Source: EIB website.

A number of *bilateral* development agencies offer guarantees in their development assistance programmes. Examples have already been given of AFD's projects in microenterprise (Box 2.7), USAID's promotion of municipal bonds (Box 2.6) and DFID's initiative for guaranteeing local currency lending (Box 2.8). The Dutch FMO also has a number of interesting projects (Box 2.13), and KfW also has some cases. This catalogue is offered for illustration and is not intended to be fully inclusive.

The level of bilateral guarantees has been unofficially placed in the range \$200-300 million annually in recent years. In the last few years guarantees by IFIs have been equivalent to c. 9 per cent of their combined programmes, but bilateral agencies' guarantees have represented no more than half of 1 per cent (0.005) of bilateral aid. Guarantees are even smaller in proportion to direct investment, but potentially more important in relation to bond lending. Over this period international bank lending and portfolio investment were negative, implying sizeable net repayments and repatriation of capital.

Box 2.13. Use of Guarantees by the FMO

In the *Russian agricultural sector* FMO and Rabobank International set up a €15 million guarantee facility to finance Russian imports of essential agricultural raw materials. The facility is linked to the practice of “ownership-based lending”, where Rabo Invest imports on its own account raw materials such as raw cane sugar, grain, malt and sunflower seeds for Russian consumers, which are then sold to the eventual customers for a price which includes a financing fee. FMO’s involvement creates a conduit for other Dutch banks to become involved in this area.

In *Bangladesh* FMO has linked up with Standard Chartered Bank (SCB) and IFC to set up a guarantee facility of \$52 million for six local private banks. The guarantee will allow SCB to issue confirmations for letters of credit to be opened by the six banks. The project will draw the local banks into financing trade, and also contains technical assistance for the banks in the areas of credit policy, implementation of international accounting standards, and corporate governance.

In *Mexico* FMO provided a partial guarantee of \$4.8 million for the placement by two Mexican mortgage banks of a mortgage-backed bond on the local capital market. The proceeds will be used to sustain house-building for low- and middle-income householders. The bond is expected to be taken up by local savings and investment funds. It is believed that this transaction could be the forerunner of a boom in the issue of mortgage-backed securities. The transaction received an AAA local rating from leading ratings agencies.

In *Peru* FMO and the IADB guaranteed the issue of a \$50 million bond on the local market by Grana y Montero, the leading construction and infrastructure services group in Peru. The agencies’ partial guarantee raised the bond rating to AA+, the minimum needed actually to place the bonds. This enabled local pension funds to subscribe.

Finally, in a case in *Kenya* FMO is joining a financing package also involving IFC and EIB. FMO is offering a loan and guarantee with a total value of \$13 million to the Magadi Soda Co, which is a by-word for socially responsible entrepreneurship. The proceeds will enable a new facility to be built turning out a higher quality product for sale to glass-makers.

Source: FMO website.

Notes

1. World Bank data.
2. The decentralisation of operational responsibility for water services often leaves tariff setting in the power of locally elected officials. In this context, the author recalls a remark by an industry contact, who shall remain anonymous: “Turkeys don’t vote for Christmas; Mayors don’t approve tariff increases”.
3. Up to date details of MIGA’s policies are available on its website at: www.miga.org
4. Some IFIs go further in their efforts to reassure co-lenders, for instance by taking on junior (subordinated) debt which is repaid after the senior debt – offered to syndication partners – is serviced.
5. Commercial companies providing financial guarantees, some of whom will only pay a claim after it has been adjudicated. They differ from “monoline” insurers, whose only business is providing financial guarantees, and normally pay claims quickly, and challenge the claim, if necessary, afterwards.
6. This has the incidental effect of reducing the guarantor’s exposure to the project in the event of a devaluation.
7. Under Instruction 113 of the *Superintendencia da Moeda e do Credito*. The background to this, and further references, are contained in Winpenny (1972).
8. For instance, in early 2003 the spot rate for Pakistan rupees was R58.2 per US\$, compared with R34 at project completion.
9. From MIGA, IFC data, and Jordan (2004).
10. EBRD Press Release, 24 July 2003.

Chapter 3

Costs and Potential Distortions of Guarantees

This chapter considers some of the potentially negative features of guarantees, including the costs to the donors and guarantors, and the costs and distortions arising in the host countries and recipient organisations. It concludes with a mention of some theoretical objections from the “moral hazard” and “rent seeking” literature.

Costs to Donors and Guarantors

The costs to the suppliers of guarantees include:

- ◆ Opportunity cost of the contingent liability – the commitment of resources that have alternative uses.
- ◆ High transaction costs in creating the product – the monetary costs and effort involved in devising and marketing the guarantees.
- ◆ Diversion and dilution of aid effort – the focus on aid mechanisms that are not well understood and which offend against the desire for transparency.

Opportunity Cost

Insurance and guarantees are not normally offered free to the users. There is normally some attempt at actuarial balance, with premiums set to recover some or all expected outlays. Markets, meaning in practice credit rating agencies, calculate a value for specific guarantees (e.g. in terms of their impact

on credit enhancement for bond issuers) which can serve as the basis for pricing the guarantee. If agencies get the pricing of their guarantees “right” no subsidy is involved, expected future pay-outs can be met from premium revenues, and there is no opportunity cost from the scheme.

However, most guarantee schemes have not been in operation for very long and the risks they cover are very open-ended. Consequently there has not been experience of risky events over a sufficiently long period to serve as the basis for actuarially determined premiums. There is rarely any closely comparable private market for risk cover in these cases; hence there is no reliable pricing yardstick. It is also difficult, if not impossible, to determine the probability of such open-ended risks as political, regulatory and contractual risks. Insuring credit risk requires a large number of cases in order to create a balanced portfolio of risks, and in the developing countries that are the targets of guarantee programmes the number of cases is still small in statistical terms.

In short, there is no basis for believing that guarantees offered in developing countries by aid agencies and IFIs are correctly priced, in the strict insurance market sense. In principle they could be either over- or under-priced. Agencies with a strict mandate to be self-financing and market-oriented might be expected to err on the side of over-pricing, while agencies using grant funds and with a remit to operate in poorer countries might err in the opposite direction.

Where under-pricing occurs a subsidy arises, being the difference between the premiums actually charged and those necessary to cover the full actuarial risk. Subsidised schemes have an opportunity cost, consisting of the reduction of public expenditure elsewhere (or alternatively, extra taxation raised) in order to create the contingency reserve necessary as cover for the guarantee programmes. Depending on national budgetary conventions, governments should create a reserve in their public spending programmes to cover unfunded contingent liabilities. The amount set aside should be the present (discounted) value of the expected value of the liability, less the premium income¹.

When insurance claims are made and guarantees called, the payments enter government accounts like any other outlay. In reality, few, if any, claims have been recorded so far². An important factor to bear in mind is that IFIs and bilateral agencies have a treaty relationship with national governments which makes the latter extremely reluctant to default on their obligations because of the wider repercussions of such actions. The loss of credit standing due to a default is another factor to be taken into account. However, the fact that guarantees offered by IFIs and bilateral agencies are rarely called does not mean that they are costless. The true opportunity cost of such products is

in the provisions made against them in the agencies' balance sheets. In a number of agencies, guarantees are "scored" at their full face value, implying the same capital provision as if an equivalent loan was made.

High Transactions Cost of Product

With the exception of political risk cover, a well established product with a long track record, guarantees are of recent origin and are still evolving to meet demand. Breach of contract and regulation risk cover entails a heavy legal input in each case, while credit risk requires due diligence scrutiny of clients, many of which are not well known in the market.

The problem is even greater for foreign exchange risk cover, and is one reason, among others, why no market has developed for this product. The one case that has been signed so far required a heavy preparation cost for OPIC³.

Diversion and Dilution of Aid Effort

Some donor governments are uncomfortable with the growth of guarantees offered by development agencies because they appear to divert development co-operation into areas of marginal priority, of concern mainly to middle income countries. Such donors argue that recent moves to include guarantees in the reporting of aid to the DAC⁴ presents a false picture of national aid contributions.

In recent years, the DAC has used its influence to persuade aid donors to include a higher proportion of pure grant in their reported aid totals. Grant aid does not create indebtedness amongst aid recipients, and is a fully transparent indicator of the cost to national donor exchequers and the subsidy to recipients. Lending at a concessional rate is less transparent (the cost to the donor being the grant element⁵ of the loan). On this spectrum, the cost of a guarantee is even more obscure, since the value and probability of the risk events are very difficult to quantify, there is little experience in using them, and even less of them leading to actual disbursements. Donors are unclear how to provision for guarantees. On its part, the DAC's convention is to allow donors to report contributions to creating guarantee funds as aid, as well as payments out under guarantee schemes as they arise. Recent discussions in the DAC concerning possible changes to these reporting conventions have been inconclusive⁶.

Costs to Recipients and Host Countries

The costs of guarantees to host governments and local capital markets should also be reckoned in the balance. They include:

- ◆ Financial costs – the charges and premiums for use of guarantees.
- ◆ Competition with sovereign debt, causing complications for host governments trying to raise finance.
- ◆ Creation of capital market distortions, crowding out other sources of capital in “unfair” ways, and the disturbance to existing market relationships.
- ◆ Creation of macroeconomic problems through the build-up of unsustainable debt and credit inflation.

Financial Costs

Guarantees do not come free, and their cost is normally passed on to the investor or borrower. Private insurers need to charge fees and premiums which are actuarially set to recover the expected cost of the insured events. Public insurance and guarantee agencies also aspire to charge “market related” fees, though, as the earlier discussion noted, this is difficult to confirm for risks (e.g. political risk) lacking the usual statistical track record.

It would be wrong automatically to assume that public agencies subsidise their premiums. For most of them, these are recently introduced products, the pricing of which is an art evolving in the light of experience and market reactions. But at present it is difficult to rebut suspicions of subsidy on the part of public insurers, who in any case are not normally required to make a profit, and whose premiums are influenced by their low claims record. The premium rates of investment insurance are not covered by OECD consensus rules designed to curb subsidies by national agencies. One major global private insurance company is reported to have decided not to provide political risk insurance because of “sub-economic” rates offered by official agencies (Jordan, 2004).

The cost of insurance and guarantees varies according to market conditions, the risk concerned and the nature of the cover. It can either be a stand-alone fee as a percentage of the transaction, or it can be added to the cost of a loan. As an illustration of orders of magnitude, in 2003 premiums for political insurance from MIGA and private insurers had converged to around 1 per cent, compared to c. 0.8 per cent from official bilateral insurers (Jordan, 2004).

Insured loans are generally classified as lower risk for the purpose of assessing capital adequacy. This leads many banks to insure themselves as a matter of course for loans to emerging markets, regardless of specific country risk ratings (Jordan, 2004). This cost is borne by all borrowers, and those with lower risk could justifiably complain that they were paying excessive premiums.

Disturbance to Existing Relationships

Guarantees enhance the credit standing of borrowers and reduce the risk of lending to them, enabling them to borrow on more favourable terms. Governments, who are typically the main borrowers in the local capital market through the issue of bonds and treasury bills, would have to offer better terms to lenders in order to raise the amounts of money they need. In immature capital markets, governments have a sheltered and privileged position in that they are the major outlet for local savings and can offer a safe haven for deposits of financial institutions. This is often reinforced by regulation or informal coercion. Guarantees broaden the market for savings outlets, and mean that governments have to pay more to raise money in local markets. For this reason, central governments have been known to oppose the growth of credit enhancement to sub-sovereign borrowers.

Guarantees can also be used financially to empower entities which previously relied on local banks. In such cases a local banking cartel may resent the new competition. However, what local interested parties perceive as a “cost” could be viewed as a benefit by the client of the guarantee, and there is likely to be a net gain for the economy.

Creation of Capital Market “Distortions”

A glance at Box 2.3 illustrates the potential impact of guarantees on fledgling capital markets. The offer of a PCG frequently halves the interest rate and doubles the maturity of loans. In many cases, it makes the difference between getting a loan or not, or investing or not. If distort means to “change the form of...to twist out of shape...to give a misleading or false account or impression...”⁷, then guarantees are clearly distorting since they affect, often drastically, the terms under which financial and investment transactions take place.

However, guarantees are introduced into markets that are already distorted, with the aim of compensating for those distortions. The following questions are apposite:

- ◆ Are guarantees successful in removing or offsetting existing distortions?
- ◆ Do guarantees introduce distortions of their own?
- ◆ Do they over-compensate for the distortions that they were intended to correct?
- ◆ Are the new distortions produced by guarantees justified by the gravity of the distortions they have corrected? Are there circumstances in which they can be given the benefit of the doubt because of the greater good they achieve?

These are difficult questions, which will be considered further in Chapter 4. Three preliminary points can be made here. First, guarantees against contractual and regulatory risk intend to correct a “policy failure” in the shape of the risk of public authorities defaulting on legal obligations, and the failure of competent/independent regulation. Although the legalities of such cases are seldom black and white, in principle, guarantees and insurance schemes that protect parties against bad government can hardly be described as a distortion.

Second, guarantees can help to address the “market failure” present in certain public services which makes them less attractive to private capital. Guarantees can help to correct this handicap, for instance by enabling longer term loans at lower interest rates, or covering operators against political pressure to keep tariffs down. Such market failure may arise because the financial returns from this kind of investment understate the full social benefits from the service. A striking example is investment in basic household sanitation, which has a dismal financial record, but a very high social benefit-cost return when its health benefits are properly included (Evans *et al.*, 2004).

Third, there is no absolute yardstick or “ideal state” against which to judge the impact of guarantees. The circumstances in which they are used are typically underdeveloped or recently emerging capital and investment markets, in many cases severely distorted (*repressed*) by government action. While there may be agreement amongst many observers about the most obvious reforms to make, it would be more difficult to find consensus about the “ideal” enabling environment and infrastructure for financial and capital markets in countries in different circumstances and stages of development. In other words, there is no single blueprint of capital market development to use when contemplating the impact of a guarantee programme.

A fuller discussion of this issue is given in Chapter 4, which reviews some recent literature on the role of financial markets in development, and assesses the possible impact of guarantees in this light. Examples are given of the negative impact of government policies on the development of banking in Africa to illustrate the local distortions that guarantees are designed to counter. The case of Mexico is discussed to illustrate how guarantees “go with the flow” of reforms to financial policies and capital market development.

Creation of Excessive Debt and Credit Inflation

Guarantees generally lower the costs of borrowing. This makes a given volume of credit more affordable, but by the same token it could encourage a borrower to take on more debt than otherwise, which could be difficult to service in the long term. This would not, of course, apply to insurance and guarantees for equity investment. Also, guarantees for borrowing locally reduce the need to raise foreign capital, thus avoiding foreign exchange risk.

The major international debt crises of recent years (Mexico, Argentina, Philippines, Russia, etc) are a sombre warning of the dangers of taking up excessive amounts of foreign debt. The current interest in increasing direct funding of sub-sovereign entities also carries potential risks if it leads to the uptake of unsustainable debt for unsound purposes by bodies that are not fully under the control of the central ministry of finance. In Mexico, for instance, bond issues by quasi-government bodies have been on a large scale, and represent contingent liabilities for the federal government. If properly reckoned, they would increase the 1999 public debt to GDP ratio from 28 per cent to 44 per cent (World Bank/PPIAF, 2003*b*). In Brazil, large-scale borrowings by state governments make up a major part of the high level of public debt, which is now a serious problem for macroeconomic management. In a similar vein, guarantees to local banks could provoke excessive lending which in certain cases could be inflationary.

However, some perspective is necessary. Firstly, the volume of guarantees is small in relation to the creation of debt, whether this is considered nationally or internationally, or sovereign and sub-sovereign level. Secondly, and more importantly, the problems noted above arise fundamentally because of failures in macroeconomic management. With transparency, proper fiscal ground rules for sub-sovereign entities, and sound monetary policy, serious problems can be avoided or minimised. In fact, the use of guarantees as one tool in the development of stronger and more diversified capital markets can make macroeconomic management easier.

Theoretical Objections

Three theoretical objections to guarantees are:

- ◆ Moral hazard – aggravating the risks they are designed to counter;
- ◆ Adverse selection – introduction of a bias towards bad risks;
- ◆ Rewarding rent-seeking – creating unnecessary profits.

Moral Hazard

Moral hazard arises from any action, designed to reduce the risk of an event, which may have the perverse effect of increasing the risk of that event happening. The concept has been extensively studied in the literature of insurance and the provision of safety nets for financial institutions.

In a commonplace example, there is a possibility that people with an insurance policy will take greater risks than if they were without it. For instance, the owner of motor insurance may take less care over driving, parking, locking the car, etc., knowing that he or she will be financially covered against damage or loss. In this case the insurance causes insured persons to take fewer measures to prevent misfortune, with the result that the *ex ante* probability of the insured risk increases. In extreme cases, insured parties may deliberately and fraudulently bring about the event they are insured against if compensation exceeds the market value of the asset plus the premium. This is a familiar suspicion in cases of arson and household theft.

Bank deposit insurance can incur moral hazard by “reducing the possibility of loss from bad business judgements”⁸. Insured banks may abuse guarantees or insurance schemes by favouring high-risk loans and investments, knowing that they will retain the gains if successful, and be protected from loss in the event of failure. The issue arises in a similar form where central banks, or international lenders of last resort such as the IMF, provide safety nets for banks or governments facing liquidity difficulties. Moral hazard is created if the existence of the safety net causes more reckless behaviour than its absence⁹.

In the United States, the concern to minimise moral hazard was a major influence on the legislative response to the liquidity problems of banks and savings and credit bodies (“thrifts”) between 1982 and 1994. In a similar vein, the question of whether IMF lending causes imprudent behaviour is a recurring feature in discussions of the Fund’s policies¹⁰.

The most common response of agencies to potential moral hazard is to leave a material portion of the risk with the client. For instance, the Partial Credit Guarantees offered by the IFIs and USAID's Partial Loan guarantees typically cover 50 per cent of risk. Another response, for public sub-sovereign clients, is to require a *counter-guarantee* from the central government. This is customary for World Bank/IBRD products and for public sector operations of other IFIs. In such cases, the assumption is that pressure from the central government will dissuade the sub-sovereign client from default.

Parties have to factor in the indirect cost of default, which is the cost of damage to their future credit standing (the higher borrowing cost following downgrading from credit rating agencies)¹¹. Private monoline insurers have a different approach, which is to offer 100 per cent comprehensive cover against all risks ("Total Wrap"), the cost of which is a higher premium and vigorous action against defaulters.

Adverse Selection

The existence of insurance, guarantees and safety nets may increase risk where it biases the portfolio of assets held by banks and companies, and attracts the more risk-prone amongst the insured population.

People who are more liable to be ill (e.g. because of family history) or face accident (e.g. because of where they live or their occupation) are more likely to take out health and life insurance. Unless insurers take steps to screen out or surcharge high risk clients, they will accumulate a skewed portfolio of the general population, with fewer "normal" risks to pay for the higher risk premium holders. Likewise, bank deposit insurance may lead banks to build up an excessively risky lending portfolio, since downside risk is reduced or eliminated. The offer of loan guarantees could have the same effect, by reducing the need for the normal scrutiny of credit applications and the pursuit of "due diligence" enquiries.

An important factor in adverse selection is the so-called "information asymmetry" between insurers and insured. Insured parties can be expected to know more about their true riskiness than the insurers do. Low-risk people will either not insure or will inform insurers of their status, and claim favourable premiums and other terms. High-risk groups have an incentive to conceal pertinent facts from the insurer. The insurance company's portfolio is skewed, and its chances of breaking even are compromised.

In banking, the analogous behaviour is that risky borrowers are unlikely to reveal all relevant information, whereas sound borrowers with excellent prospects and good security will use this to get favourable terms. In this situation, the credit risk premium will be insufficient, and the bank will be unable to recoup from sound borrowers sufficient to offset losses from those at higher risk of insolvency. Guarantees would make this prospect worse if they discouraged banks from making all due enquiries about the creditworthiness of borrowers.

In this connection, the enquiries conducted during a recent review led one author to conclude:

“...equity investors and private banks who insure stressed that PRI [political risk insurance] does not affect the need for a thorough assessment of project fundamentals nor lead them to accept an ‘unsound’ project. Many are sceptical about prospects for claims being paid. By contrast, some investors considered the political umbrella of participation by a public sector financial institution, such as IFC, in a project (as equity investor or lender) may be a deal-maker” (Jordan, 2004).

Rent Seeking

Guarantees aim to change behaviour by providing comfort against risk. In theory, they allay the risk averseness of lenders or investors to the point where they are persuaded to undertake some action that they would not otherwise do. Where the lender/investor would have proceeded without the guarantee, the latter is redundant, and confers an unnecessary benefit on the party concerned.

Where lenders and investors actively seek guarantees as a means to obtain extra benefits, without any more outlay of resources, this would be an example of *rent seeking behaviour*¹². Rent seeking has been analysed in various economic situations where restrictions imposed by governments create artificial scarcities which provide *rents* for those lucky enough to get access to the scarce resources, e.g. import licences (Krueger, 1974).

There is no doubt that guarantees enable borrowers to raise funds at lower interest and/or longer maturities and give those borrowers a benefit (an increase in the present value of the loan) which they may not have expected, and may not need. Again, an investor who, having carefully assessed risks, fully intends to proceed with a project may take out contractual and regulatory

risk cover to eliminate some of the downside risk. This would effectively increase expected profits, though it should not be forgotten that guarantees are not provided free.

It is conceivable that the availability of cover may lead the investing firm to try to turn the contract more to its advantage and increase the stakes in the deal. If successful, the reward is a more profitable contract; if not, the insurance is called.

A hint that Breach of Contract insurance may affect behaviour is contained in feedback from private insurers during a recent survey:

“Private insurers dislike providing ‘denial of justice’ cover since they consider the requirement to go to arbitration is overly confrontational ‘buying a conflict’. They offer ‘contract frustration’ cover, although this is generally only for short (renewable) terms” (Jordan, 2004).

It is doubtful, however, whether any of the above behaviour can be categorised as rent-seeking, which can only arise where there is an artificial scarcity of the item concerned (the guarantee) which beneficiaries compete to get. In practice, feedback from the originating agencies and market observers is that, at least for infrastructure, there has been a low level of demand for available guarantee products, and that supply is not a constraint. As Jordan (2004) concludes in his survey of political risk insurance:

“None of the investors interviewed that had sought PRI had found difficulty in obtaining it.”

Notes

1. The expected value is the actual cost of the liability multiplied by the probability of it happening.
2. E.g. IFC has made no payments so far on its guarantees, nor has the World Bank – though the latter was close to being called during the Argentinean crisis.
3. This has led to consideration of designing a common facility for whole sectors, or for all infrastructure projects. But this could amount to a prohibitively large liability for the sponsor.
4. The OECD's Development Assistance Committee. The DAC's Statistical Reporting Directives define overseas development assistance ("aid") as a flow of resources that derives from an official body, is targeted at economic development, and has a concessional element of at least 25 per cent.
5. The present value of the stream of repayments, discounted at a rate of interest representing the market rate.
6. Majority opinion in the DAC at present favours noting them as "memo" items rather than incorporating them into aid flows alongside grants and loans. However, the topic continues to be discussed.
7. From the New Oxford Dictionary of English, 1998.
8. Tigert Helfer (1999).
9. Recall the analogy of a safety net and a tightrope walker!
10. Lane and Phillips (2001); Cordella (2004); Rogoff (2002), etc.
11. The analogy with private motor insurance is the size of the "excess" which has to be met by the insured person, and the impact of a claim on the size of future premiums.
12. In economics, a rent is an "excessive" reward to a scarce factor of production (land, labour, enterprise) over and above its supply price – the price required to induce production. In other words the rent does not correspond to any real cost of production, and if it is eliminated (e.g. by a tax) this should not affect production.

Chapter 4

The Developmental Impact of Guarantees

This chapter assesses the developmental impact of guarantees. The argument takes the following form:

- ◆ *The development agenda is one in which there is a strong international commitment to expand physical infrastructure, develop financial and capital markets, and promote private enterprise at all levels.*
- ◆ *There are powerful market and policy failures to compensate for.*
- ◆ *Financial and capital markets are highly distorted (repressed) in many countries and any distortions of their own that guarantees introduce have to be viewed in this context. There is no blueprint for the “ideal” financial and capital market.*
- ◆ *Guarantees help to move financial and capital markets in the right direction, from the standpoint of development and poverty alleviation. At the very least, they “go with the flow”.*
- ◆ *The investment projects that guarantees help to promote are desirable and defensible in themselves.*
- ◆ *Guarantees are relatively minor instruments of development policy in quantitative terms, and, where they are used, make a modest difference to the amount of lending and investment in infrastructure.*
- ◆ *The agencies concerned are seeking to adapt their products to make them more relevant and interesting to clients.*
- ◆ *Guarantees are potentially applicable in many development contexts, but they work best where they have a strong Enabling Environment in support.*

The Development Agenda

The commitment of the international community to the Millennium Development Goals provides the overriding moral momentum for the expansion of economic and social infrastructure in the developing world. But without a major expansion of existing funding sources or the emergence of new ones, the MDGs are going to be seriously underfinanced (Reisen, 2004).

In the sub-sector of household water and sanitation alone, additional *annual* investment costs of at least \$10 billion, and possibly up to \$30 billion, depending on estimates, will need to be raised over the next decade. It is reasonable to look to conventional aid sources for a proportion of this, but the remaining gap will be sizeable (Smets, 2003). Taking a broader view of the water sector, including wastewater treatment, irrigation, hydropower, flood control, environmental protection, etc., the additional *annual* investments could amount to \$70-80 billion (Winpenny, 2003). In the power sector, the massive investments required to keep pace with the industrial expansion of India, China, Brazil and other emerging economies imply funding increases of a similar order of magnitude.

Much of the required funding will need to come from local sources. Even the funding provided from international sources typically complements, or is intermediated by, local financial institutions. In this context, there is now a full appreciation of the importance to development of good national financial infrastructure:

“It is obvious that advanced economies have sophisticated financial systems. What is not obvious, but is borne out by the evidence, is that the services delivered by these financial systems have contributed in an important way to the prosperity of those economies. They promote growth and reduce volatility, helping the poor. Getting the financial systems of developing countries to function more effectively in providing the full range of financial services – including monitoring of managers and reducing risk– is a task that will be well rewarded with economic growth.” (World Bank, 2001)

A large body of empirical studies supports this view:

“The positive association between financial sector development and economic growth is now a well documented stylized factNumerous authors have reconfirmed positive correlations between differing indicators of financial development and growth, and several have included tests for causality”. (Jurajda and Mitchell, 2003)

Funding for infrastructure comes from a mixture of sources – sales revenue, government subsidies, loans from local and international banks, bond issues, loans and grants from aid agencies, etc. – and this pattern seems set to continue. The magnitude of the task, and the need for state-of-the-art expertise, has led many governments to turn to Private Sector Participation in implementing, financing and operating new infrastructure. PSP is exposed to a particular spectrum of risks and, as Chapter 1 demonstrated, is a volatile element in infrastructure provision.

This is the broad development context within which guarantees operate. Their advocates would claim that they facilitate investment in infrastructure, aid the development of local financial and capital markets, and mitigate the risks of PSP¹.

Market and Policy Failures

In an “ideal” world where markets functioned well, institutions were highly developed, prices reflected social and well as private values, there was full information and perfect foresight, and governments maintained the rules of the game wisely and impartially, there would probably be no need for such devices as guarantees. But this catalogue advertises how far we are from this economists’ Utopia. Market and policy failures are widespread, especially in the realms of infrastructure and microenterprise finance, and guarantees have arisen to compensate for them.

Some examples of market and policy failures² are the following:

- ◆ The presence of *externalities*. The supply of certain public services such as safe drinking water, basic household sanitation and adequate wastewater treatment has social, public health and environmental benefits which are not reflected in the price charged. There are analogous arguments for the universal provision of electric power, and possibly other infrastructure. In theory, these services are underprovided by the market, and need a subsidy.
- ◆ Imperfect or asymmetric information about the costs and/or benefits of the projects in question. This applies particularly to PSP cases or lending by international banks and agencies. It is not uncommon for operators or investors to bid for, or take over, an existing system, without sufficient

knowledge of the assets, financial situation or the customer base. The investor or lender is often at a disadvantage compared to the existing incumbent or seller, who has the benefit of *asymmetric information* of the project.

- ◆ Tariffs may be kept below full cost-reflective levels because of consumer resistance or political interference. This is a particular problem for water and wastewater projects.
- ◆ Breach of contract by public authorities or political pressure on an “independent” regulator to decide in the government’s favour.
- ◆ Ill-defined or contested property rights, or more generally a weak framework of commercial law and legal redress through courts. These are problems potentially affecting all lenders and investors.
- ◆ High transactions costs involved in bidding, contract preparation, implementation and subsequent litigation.

Insofar as guarantees mitigate these risks they compensate for the market and policy failures that are present (Chapter 2). The case of financial capital markets is a particularly serious policy failure, to which we now come.

Distorted Financial and Capital Markets

Financial markets perform several basic functions (Ul Haque, 2002):

- ◆ Mobilising savings, by providing an outlet for savings with the features (liquidity, profitability, security, etc) desired by savers.
- ◆ Allocating capital, providing loanable funds for borrowers with characteristics matching those desired (cost, maturity, collateral requirements, etc) and ensuring that savings and firms’ retained earnings are employed productively.
- ◆ Transforming risk by giving opportunities for aggregating and repackaging it. Markets pool resources and diversify ownership.
- ◆ Providing a transparent environment in which the different agents can be monitored and made accountable for their performance. Markets produce information and prices, and promote efficient governance of firms by creating external pressure and discipline on their operations.
- ◆ Offering efficient clearing and settling procedures.

In recent decades the predominant model of financial reform has developed in response to the thesis of *financial repression*. It is argued that government controls over interest (and exchange) rates have discouraged the growth of savings, led to sub-optimal allocation of loanable funds, and limited the growth of competition in financial markets. On this view, the solution is liberalisation, lifting controls on interest rates to allow market-clearing levels to prevail, and permitting competition amongst financial market players.

Historically³ a common reason for financial repression was a desire to stimulate investment by keeping interest rates down, and provide cheap capital to the government, the main borrower from local financial markets. However, an effect of this policy has been to discourage savers from keeping funds in local banks, where real returns have often been negative, and has encouraged a flight of capital overseas in search of higher returns. It has entrenched the government's domination of local capital markets, in many cases taking the form of state ownership of banks, and discouraged the growth of competition amongst financial intermediaries. At the low controlled interest rates, the excess demand for credit is resolved by credit rationing. Large borrowers tend to be favoured at the expense of small, where transactions costs and perceived risk are likely to be higher. Financially repressed economies tend to have low productivity of capital investment (Little, 1982).

Escaping from financial repression through liberalising interest rates and capital market entry, and lifting credit ceilings has been the ruling policy paradigm in recent years. Recent experience and empirical research strongly suggest a causal link between measures of financial development or "depth" (e.g. ratios of money, bank deposits, or other financial assets to GNP) and economic growth. Financial deepening also has an inverse relation with poverty (World Bank, 2001; Honohan, 2003). These findings support the view that financial and capital markets have an *active* impact on development, which contrasts with the traditional view that they are passive agents which respond more or less to development in the "real" economy⁴.

Where the banking system is deeply dysfunctional and crisis-prone, its drag on the wider economy is obvious (Box 4.1). More specifically, research shows clearly that long term credit is scarce in developing countries, especially for smaller firms. Amongst manufacturing firms greater long-term finance is associated with higher productivity, though this relationship is reversed if the credit is subsidised. The policy implication is that governments can usefully encourage the supply of long term credit, provided it is not subsidised to any great extent (Caprio and Demiguc-Kunt, 1997).

Box 4.1. Banking Crises in Sub-Saharan Africa

A study of banking crises in 10 sub-Saharan African countries in the period 1985-95 concluded that heavy government intervention in banking was a root cause. There was a lack of a strong legal and institutional environment and a poor “credit culture” – the view that repaying loans is important.

Intervention by governments took many forms, influencing banks’ operating environment, market structure, ownership patterns and entry conditions. There was ubiquitous pressure to lend to public enterprises. In the countries surveyed there was a higher level of direct government ownership than is normal in other parts of the world. Governments used banks to further their development agenda and to favour certain sectors and firms. In return, banks used the government to intervene on their behalf, and to turn a blind eye to unprofessional practices, lending to certain individuals, etc.

The results were disastrous. In Benin in 1988, all three main banks collapsed and 78 per cent of bank loans were non-performing. In Cameroon in 1989, 60-70 per cent of bank loans were non-performing. In Ghana in the 1980s, seven of 11 audited banks were insolvent, and in Guinea in 1985 the six main banks were all insolvent. In Nigeria at the end of 1992, eight banks were insolvent and 45 per cent of bank loans non-performing. In Tanzania, government-owned banks were insolvent in 1990, and by 1994 60-80 per cent of all bank loans were non-performing.

Source: Daumont *et. al.* 2004.

The financial liberalisation thesis has been influential in policy reforms in many countries. However, the growing sophistication and complexity of financial markets has exposed the original thesis to be too focused on commercial banks. Other financial institutions, such as stock markets, pension funds, insurance companies, savings banks, merchant banks, building societies, etc. are an important part of financial deepening. Recent thinking has stressed the potentially negative consequences of liberalisation, and the importance of taking local institutions more fully into account in designing reform programmes (Arestis, *et.al.* 2004). It is also recognised that policies towards the financial sector in developing countries need to enhance the multiple functions of financial markets, and promote diversity and competition within them (Ul Haque, 2002).

In the last resort, there is no undisputed theoretical blueprint for capital market development, and a severely pragmatic approach has much to be said for it. The IMF’s Economic Counsellor recently said:

“Institution building is one area where international financial institutions and policymakers have learned from experience and have used common sense to devise practical approaches, without much guidance from academia. And there is hope, supported by a growing body of research, that more students of development are realizing that a better starting point for analysis than a world with only minor blemishes may be a world where nothing is enforceable, property and individual rights are totally insecure, and the enforcement apparatus for every contract must be derived from first principles – as in the world that Hobbes so vividly depicted. Not only will this kind of work more closely approximate reality in the poorest, conflict-ridden countries, but it could also lead to more sensible policy.”(Rajan, 2004)

Guarantees and Capital Market Reform: Mexico, India and South Africa

The offer of a guarantee can encourage the growth of capital markets in various ways:

- ◆ Lengthening the term of credit available from local banks (e.g. by Partial Credit Guarantees), making this source of capital more attractive and viable for infrastructure development.
- ◆ Widening the range of instruments available to borrowers and lenders (e.g. by guaranteeing municipal bonds), providing alternatives to commercial banks.
- ◆ Creating safer local outlets for savings (including institutional savers such as pension funds), which also discourages capital flight.
- ◆ Encouraging the various forms of private sector participation by insuring against failures of governance (e.g. guarantees against contractual and regulatory risk).
- ◆ Giving sub-sovereign institutions more financing options, with greater independence from central government.
- ◆ Providing a collective guarantee to a number of separate entities pools their credit standing and enables them to surmount size and credit thresholds.

All of these effects go “with the grain” of models of capital market reform. The case can be illustrated from Mexico, India and South Africa.

Mexico

The use of guarantees such as in the Tlalnepantla project (Box 4.2) should be seen in the broader context of the development of local capital markets to fund a major programme of investment in infrastructure, and create new outlets for local savings.

In recent years, thanks to good economic performance and increased macroeconomic stability, there has been a decline in country risk and a clear improvement in Mexico's investment climate. Over the first decade of the Twenty-First Century it was estimated that the energy and water sectors will need \$100 billion and \$6 billion, respectively, in new investment. But public sector investment in infrastructure fell from 12 per cent of GDP in 1981 to less than 2 per cent in 1998, since cuts in public investment bore the brunt of recent fiscal adjustments.

Improvements in the investment climate since 1995 have been due to several factors: the relative flexibility of the local labour market; liberalisation of external trade, greater exposure to foreign competition and better access to imports; a sharp increase in foreign direct investment since 1994; and a comprehensive deregulation programme, which streamlined regulations and procedures. The legal framework for investment now contains better recognition of creditors in bankruptcy cases, which is expected to improve the investment environment. However, most lending by financial institutions is secured against personal guarantees and/or mortgages on property, and lenders have to undergo an expensive legal process to recover collateral.

The large volume of government and quasi-government debt outstanding dominates the markets. In 1999 federal debt amounted to over 51 per cent of GDP, and the sheer volume of government bonds, and the need to refinance them, creates upward pressures on interest rates and the risk of crowding out local private issues.

Developing local long-term capital markets is crucial to financing the country's infrastructure development. Continuing low levels of public investment will shift the focus on to private sources of finance. However, experience has shown the heavy costs and exchange risk of financing domestic investment using dollar-denominated debt. The government's strategy is to allow the foreign financing of short term investment, but to develop local sources of finance for long term infrastructure investment.

Local banks are now subject to much improved regulation and supervision. They still need more capitalisation, however, and still pursue conservative lending policies, preferring to invest in low risk public sector issues. Bank credit has failed to rise much in real terms, and loans are largely made to the biggest companies. Long term financing is not available except to those with standing in international markets. Real interest rates are high, and this has also restricted demand.

Mexico has a state development bank for infrastructure, BANOBRAS⁵, which hitherto has provided long term loans to states and municipalities, borrowing itself from IADB and the World Bank, and issuing its own debt and notes with guarantees from the federal government. BANOBRAS also operates a currency swap facility, which enables it to borrow in foreign currency and on-lend in pesos. The Bank is unlikely to play such a large role in the future as previously, since its federal guarantee for lending and debt service is removed, and in any case the bank is rather cumbersome and bureaucratic. Its future role is likely to be more as facilitator than direct provider.

Recent macroeconomic volatility has left its mark on the trading pattern of local capital markets, which are dominated by short term debt instruments. In 2000 the Government successfully issued 3-5 year debt, which was a step in the direction of lengthening the yield curve.

The new pension system for private sector workers, managed by the SIEFOREs⁶, has assets of \$19.7 billion by mid-2001. The SIEFOREs operate under a highly restrictive regulatory regime that allows them to invest only in highly rated domestic peso-denominated fixed income investments. The availability of infrastructure finance would be transformed if these savings could be placed into equities and private corporate securities.

Private debt and equity alone is unlikely to suffice for the finance of new infrastructure in Mexico. Public support will be required. The difficult financial environment of the 1990s caused project managers to mitigate their risks so as to reduce the cost of capital and increase their project's viability. In 2003 a report of the World Bank and PPIAF concluded:

"Mexico needs to develop a diversified set of financial instruments to deepen funding sources, to extend maturities, and to blend direct public investment with guarantees depending on the nature of specific project risks." (World Bank/PPIAF, 2003b)

The same year saw a revival of the Mexican municipal bond market after 90 years' dormancy, which owed much to the World Bank's Structural Adjustment Loan of 1998 which encouraged fiscal decentralisation and the growth of a sub-sovereign credit market. All 32 states now have a credit rating, together with 70 municipalities and other sub-sovereign entities. Since December 2001, 16 states and municipalities have raised funds in the market for infrastructure projects. There has been a massive increase in assets managed by pension funds looking for high quality outlets. There is pressure, too, on banks to lend to creditworthy local governments in order to minimise the mandatory capital reserve. Highly-rated local government paper satisfies a growing demand.

The Tlalnepantla guarantee (Box 4.2) is significant in various ways. It is the first exposure of IFC and the World Bank Group to direct municipal risk, the first time a Mexican municipality borrowed without the collateral of a federal government fiscal intercept⁷, the first financing using water fees as a primary source of repayment, and the first credit enhancement for a bond issue by a state or municipality. The financing is in local currency, and creates a new high quality asset class to develop the local capital market. Previously municipalities would have borrowed from the public sector bank BANOBRAS.

There are signs that the project is having a wider impact on local project finance. Prior to Tlalnepantla, bond issues by municipalities, backed by PCGs from federal entities, were becoming frequent. Since the project was announced, BANOBRAS has also started offering its own Partial Credit Guarantees. Very recently, a second state water project with a similar structure has come to the bidding stage. Tlalnepantla involves creating a trust for channelling revenues for paying creditors, a feature motivated by withholding tax factors. This was the first time that the payment structure of a BOT contract depends on the company's own revenues (previous BOT deals had been financed using as collateral a contingent revolving line of credit from BANOBRAS)⁸.

Box 4.2. Tlalnepantla Municipal Water Project, Mexico

Tlalnepantla de Baz is a municipality of 800 000 people within the metropolitan area of Mexico City. It is the most industrialised municipality in Mexico and accounts for 2.9 per cent of national GDP. Within Mexico, it has been in the forefront of progress in tax collection, financial and fiscal management, and reforms to its local water utility.

The Metropolitan Area has serious problems of water supply, and Tlalnepantla draws water from groundwater aquifers, of which levels are declining. The project involves the construction of a new wastewater treatment plant for recycling household and industrial wastewater for industrial reuse. Using the recycled water will release potable water to meet the growing demand from the local population, and alleviate further pressure on the aquifer. As part of the same project, a leak reduction programme will be undertaken in the water distribution system.

A trust has been created in the Banco Santander Mexicano, which issued a bond in the local capital market for 95 million pesos (\$8.8 million), the proceeds of which are lent to the municipality. This loan is secured against, and repaid from, property taxes and water user fees. The bonds have an 11 year maturity, which is long term by local standards.

Dexia Credit Local, a private financial company specialising in municipal finance, has provided a letter of credit to cover any shortfall in the debt service up to \$8 million. The IFC is covering a proportion of Dexia's obligation by means of a partial credit guarantee for a sum of \$3 million to the Trust for the benefit of bondholders. The guarantee will enhance the local credit rating of the bond from AA to AAA, without a sovereign guarantee.

Sources: IFC; Dexia Credit Local, Protego.

India

India also has a huge appetite for finance to meet the infrastructure needs of an expanding urban and industrial base. The amounts involved are daunting: one estimate is that capital costs for the water sector as a whole for 2000-2025 could be \$421 billion (Bhatia and Malik, 2000). In this case, the use of risk-sharing guarantees by international agencies (in this instance USAID) enabled smaller municipalities to obtain access to bond finance for infrastructure projects. The context is a national policy of decentralising infrastructure financing to state and municipal level, and the withdrawal of subsidies and Central and State guarantees for borrowing.

Currently, finance for capital spending in household water and sanitation comes mainly (90 per cent) from budgetary allocations, topped up by financial institutions (6 per cent) and foreign ODA (4 per cent). Current sources are unlikely to meet more than half of future needs. Recurrent O&M outlays are funded from local revenues (60 per cent), with the balance from transfers of State Governments⁹.

The Indian Government has recently delegated responsibility for water services to Urban Local Bodies (ULBs), which are being encouraged to undertake reforms and develop structures to raise funding and attract private capital. The Central Government is encouraging the issue of municipal bonds by giving them tax-free status, and a City Challenge Fund has been created to support reform initiatives¹⁰.

The old financing model, based on central and state subsidies, plus state guarantees, is being superseded by one in which local authorities are encouraged – indeed forced – into raising funds increasingly on their own account, repaid from local revenues. Until recently, State Governments were able to offer guarantees to their municipalities for borrowing from specialised public financial institutions. These guarantees have now been curtailed by ceilings being placed on State contingent liabilities. In response, several states have begun a reform agenda, including credit rating of municipalities, the issue of municipal bonds, the creation of urban infrastructure development funds, carrying out water and energy audits, reforming tariffs, and setting up Regulatory Commissions.

Some large municipalities have successfully issued their own bonds. In 1996 Ahmedabad raised Rs 1 billion with an A+ rating, the first Indian municipal bond with investment grade status, and the first municipal bond in Asia. This was followed in 1997 by a Rs 250 million bond issue by Mumbai

with an AA- rating, and further issues by Pune (AA), Bangalore (A-), and Vijayawada (A-). In 1998 Ahmedabad raised a bond for a further Rs 1 billion, in 1999 Nashik went to market for Rs 125 million, and in 2000 there were bond issues from Ludhiana, Nagpur and the Tamil Nadu Urban Development Fund (Blore *et al.*, 2004).

In two more recent cases, smaller municipalities are being given indirect access to bond markets through pool financing schemes. One of these, briefly described in Box 2.6, was in Tamil Nadu, the other in Karnataka. In both cases USAID provided credit enhancement through 50 per cent bond guarantees. Payment mechanisms included use of escrow account fed from property tax and other local government collections, and a debt service reserve fund backed by fiscal intercepts from the State Government.

A lynchpin of the above Indian model is the role of the local credit rating agency, CRISIL, an affiliate of S&P. The agency, which is now the fourth largest in the world, benefited from a USAID contract in 1995 to develop a methodology for rating municipal bonds, and in 1996 was appointed by a number of cities to carry out credit rating assessments. Although a credit rating calibrates the ability of the client institution to service a specific debt issue, the exercise has a much wider impact:

“..the rating exercise itself acts as a powerful incentive for the organisation to improve its financial housekeeping. The evidence suggests that credit rating has been significantly more effective in bringing about improvements in municipal financial management and record keeping than exhortations or regulatory controls by central government.” (Blore *et al.*, 2004).

In practice, all debt issues in India have to be rated, and practically all ratings done so far have been for *structured* operations, enhanced in various ways – guarantees, a lien on specific revenues, fiscal intercepts, *escrowing*¹¹ revenue streams, pool finance, etc. For most ULBs credit enhancement is essential for bond issues. India has the advantage of very clear centre-state-local financial relationships, and clarity over the legal powers of municipalities.

South Africa

On a smaller scale, bilateral agencies and IFC are using their guarantees to promote access by municipalities to the bond market in South Africa. This country has a coherent national water policy, based on achieving universal coverage of safe water by 2008 and of sanitation by 2010. This provides for a free basic water quota of 6 cubic metres per month for all. The national financing

strategy reflects differences in the economic status of different municipalities and rural settlements and stipulates cross-subsidy from richer to poorer local authorities. The richer towns and cities are expected to be self-financing, using stepped (*progressive*) tariffs for consumption in excess of the basic free quota to generate revenues, and using cross-subsidy from larger users and industry. For others the Equitable Revenue Act, recently superseded by the Municipal Finance and Management Act, provides for central revenue sharing by targeted fiscal transfers¹².

As in India, local credit ratings agencies are a potent check on the performance of municipalities, water boards and private companies. South Africa has a relatively well developed financial system, a large body of local savings and savings institutions, and sophisticated legal and fiscal structures. The Development Bank of Southern Africa (DBSA) is a long-established conduit for concessional loans to municipalities. Following the Government's withdrawal of guarantees for municipal borrowing in 1994 the Infrastructure Finance Company (INCA) has also been a key financial intermediary for municipal finance. INCA is a private body, raising funds in the market and lending for "general obligation" (i.e. non-project) purposes to the more creditworthy municipalities. INCA produces a "shadow credit rating" for its municipal clients based on a thorough financial and institutional assessment.

Against this relatively propitious background, international guarantees are starting to be used to give municipalities direct and indirect access to bond issues in the local market¹³. The bond issue made by Johannesburg (Box 2.3) was the first municipal bond issue in sub-Saharan Africa made without a formal sovereign guarantee. The issue had several purposes: to diversify funding sources, reduce the cost of borrowing, extend loan maturities, release escrow accounts and start a municipal bond market. Credit enhancement provided by the DBSA and IFC raised the city's credit standing to AA-, which triggered the entry of pension funds to the issue. The issue brought in 15 new investors, including pension funds. The achievement is all the more remarkable in that the city has not had a "clean" audit report for 10 years, mainly owing to the large number of household accounts in arrears¹⁴.

For smaller towns IFC and AFD will provide a collective credit guarantee to 90 or so loans made by the DBSA to various municipalities in a securitisation scheme. A special purpose vehicle (Collateralised Loan Obligation) is created to take over the risk of these loans. DBSA would meet the first layer of loss from any default, the IFC and AFD would take equally the second layer of loss (mezzanine layer), and the remaining risk would be met by the institutional investors with senior bond holdings¹⁵.

Impact on the Quality of Investments

Any action which lowers the interest charged on a loan will have a dual effect – increasing the volume of projects funded, and leading to the choice of projects which would have been unprofitable on the previous borrowing terms. This applies particularly to credit guarantees, which may flatter to deceive.

Guarantees which reduce generic risks, such as political and contractual/regulatory, are also likely to increase the flow of projects, but with the difference that the alleviation of risks will increase the real profitability (expected value) of those projects. Nevertheless, the greater number of projects that will, in principle, be funded opens the possibility that lower priority schemes will proceed.

One way of countering this accusation is to use social cost-benefit analysis to give full weight to non-financial aspects of projects. For example, irrigation and household water projects normally have a higher economic than financial rate of return. To some extent, development agencies use appraisal methods which take these non-financial aspects into account, though financial decision rules normally prevail. IFIs and bilateral agencies claim to apply their normal appraisal and due diligence criteria to insurance and guarantee applications, as if they were making a direct loan from their own resources.

MIGA's political risk insurance depends on projects being "financially and economically viable, environmentally sound, and consistent with the labour standards and other development objectives of the host country" (MIGA website). In Partial Credit Guarantee cases, IFC follows normal due diligence enquiries as if it were lending directly, and supervises the guaranteed agency throughout the life of the instrument (IFC website).

The financial selection criteria used by development agencies are at least as rigorous as those used by commercial entities, and in addition include various non-financial development criteria not normally applied by market players. Compared to market operators, development agencies tend to operate in poorer countries with less developed financial markets, where there are good prospects of value-added from rigorous appraisal and supervision.

It may be argued in contradiction to this that agencies, under pressure to expand their guarantee programmes for infrastructure, may take on marginal cases and give them the benefit of the doubt during appraisal and supervision. However, this could also apply to commercial lenders and insurers, competing for business in the current harsh international financial climate.

A more subversive point is that, like grants and loans, guarantees are *fungible*¹⁶, and may release lending capacity and risk-taking for other ventures. For instance, a bank which takes out insurance or guarantees in order to evade a capital provisioning requirement preserves this lending capacity for some other purpose, beyond the knowledge or control of the guarantor. It is difficult to assess the likelihood of fungibility in specific situations. A safe, but innocuous, conclusion would be that the true impact of a guarantee may well extend beyond that of the specific purpose for which it is issued. However, the same is true of any kind of aid or commercial loan. Projects supported by guarantees are probably as sound as, and probably more worthy than, those backed by other means.

Quantitative Impact

Chapter 2 presented evidence that in the last few years public guarantees have been minor when set against flows of conventional development finance. They have been most important in the programmes of the IFIs, accounting for 9 per cent of their combined operations over the period 2001-3, but schemes operated by bilateral development agencies are likely to have been well below 1 per cent of their development programmes.

The best documented schemes are those of the IFIs. The World Bank family of agencies and all the major regional development banks operate various types of guarantee programmes. Compared to these, development guarantee schemes run by bilateral agencies are fewer, more exiguous, and are so far not consistently or comprehensively reported to the DAC. Information is available from the Berne Union on political risk insurance from private insurers and official bilateral insurers operated for commercial motives. These provide comparators for MIGA and other development schemes.

To gain perspective, in 2003 it is estimated that \$15-18 billion of new political risk insurance was issued, in the following proportions (in \$ billion): MIGA 1.3, bilateral official insurers 8.8, private insurers 6.7. Moreover, private insurers have a higher proportion of their policies in countries in the higher risk categories, compared to official bilateral insurers. This is mainly due to the preponderance of Latin American cases in the portfolios of US companies (Jordan, 2004, based on Berne Union and private estimates).

These overall yardsticks may not do full justice to the importance of development guarantees. MIGA, the major IFI source, has a specific mission to complement other insurers, specifically by focusing on low-income countries. In the period 2001-3 the IFIs issued no traditional political risk insurance in investment-grade countries, and 50 per cent of policies were in countries with a C-grade or without any rating (PriceWaterhouseCoopers, 2003).

Whether guarantees stimulate investment and lending which would not occur otherwise is the crucial question. The conclusion of one recent survey in respect of political risk insurance is:

“PRI [political risk insurance] is not considered a key factor in determining investors’ investment decisions. Among equity investors interviewed who have rejected or curtailed investment, the availability of PRI was not a significant factor in their decisions. However, the major users of PRI are banks that require insurance as a matter of general policy, and this often creates constraints for project promoters to access long-term debt financing. The banks and equity investors who insure consider PRI as a comfort rather than a major influence on their investment decisions. They typically consider that ‘PRI will not make a bad deal better’. None of the investors interviewed who had sought PRI had found difficulty in obtaining it. Thus, while the availability of PRI helped support the expansion of investment in the 1990s, it seems unlikely that a global increase in the supply of PRI would stimulate additional investment.” (Jordan, 2004.)

This begs the question of the impact on investment flows of a “comfort” rather than a “major influence”, to which there is currently no clear answer.

Making the Products More Relevant

All the IFIs offering guarantees report a low level of uptake of their products. The use of guarantees is currently constrained by weak demand rather than supply. However, the range of products currently on offer does not fully match potential demand. These mismatches are explored in this section. Unless specifically indicated, the views expressed draw on the recent surveys by PricewaterhouseCoopers (2003) and Jordan (2004). The situation varies according to the type of product.

Political risk insurance (PRI) is well established, with three decades of usage, and is familiar to capital markets. The risks that it covers are well defined, the basis on which claims can be made and payments received is well established and the role of the IFI guarantor in effecting remedies where required is understood. PRI is readily available, there is a well functioning market in different offerings, and premiums converge around a relatively narrow and predictable range. These are all attributes of an economically “perfect” market.

Despite this, PRI is little used in the water sector: since 2001 only two guarantees have been issued. IFIs attribute this to the paucity of bankable projects that could benefit from this kind of credit enhancement. Potential sponsors in the water sector are inclined to stress the greater importance of mitigating regulatory/contractual and devaluation risks.

Amongst the IFIs, MIGA has a dominant position, and the other agencies try to avoid duplicating its products by differentiating their own, e.g. relating them to their other activities. MIGA offers guarantees on a standalone basis, whereas a number of the others link guarantees to projects to which they make direct loans. MIGA does not require a sovereign counter-guarantee, whereas most of the other IFIs do, by charter or practice. Arranging sovereign counter-guarantees can be time-consuming and is best done in the context of the total country lending programme. In most IFIs lending is the priority and the volume of commitments/disbursements is the prime performance criterion. Where, as in many cases, guarantees are scored the same as loans for capital reserve purposes, they do not have priority within lending departments. Changing the scoring system (increasing the “leverage” of guarantees) would be likely to increase their attractiveness for agency staff offering these products. The fact that different IFIs have different conventions on scoring indicates some possibility for reform (Kotecha, 2004).

From the demand side, the majority of host country officials prefer direct loans to guarantees, and their understanding of the latter is limited.

On the evidence available, the supply of PRI does not seem to be a limiting factor on investment in infrastructure. There is no strong case for creating a new institution; more interesting options could be setting up aid-funded re-insurance pools to underwrite existing insurers in specific regions, and pressing bilateral official insurers to “untie” insurance to make it available to national banks financing projects in developing countries. There is also a long way to go in promoting the use of political risk insurance by developing countries’ own official insurers (Jordan, 2004).

The situation is different for *contractual and regulatory guarantees*. Although few of these policies have been issued so far by IFIs, there is a strong interest from potential users. This is especially true for the power and water sectors, where regulatory decisions and contractual disputes have bedevilled a large number of recent projects. Unlike for PRI, however, there are serious supply-side constraints on these products. As the discussion in Chapter 2 showed, these instruments are very project-specific, with high transaction costs, and claims that are often complicated and protracted. The perception of markets and users is that the process for obtaining these guarantees is complex and cumbersome, and their actual impact on financing terms is uncertain. Only two IFIs currently offer cover for equity, which leaves core investors unprotected.

In a nutshell, the market for these guarantees is still “imperfect” in the economic sense. As for PRI, the support of lending agencies and host governments for these guarantees is far from wholehearted. Crucially for their effectiveness in the water sector, they must apply to sub-sovereign entities, which introduces a whole new set of problems. Sub-sovereign bodies often lack expertise and understanding of financial engineering, and they cannot always influence key issues decided at national level. In these cases, investors may press for a sovereign counter-guarantee, which takes more time to arrange. So long as potential demand remains strong there is every prospect that the supplying agencies will evolve the product to fit the needs of users, though for the foreseeable future this type of guarantee will occupy a niche market, with a high transactions cost, and premiums reflecting this.

Both political risk and contractual/regulatory insurance is principally available for debt. Amongst the IFI schemes, equity holders are currently catered for only by MIGA and the Islamic Development Bank (Table 4.1). Thus, companies investing equity into infrastructure ventures can generally only insure their debt, leaving the general interests of their shareholders unprotected.

Credit risk guarantees (CRGs) are also in strong demand because they provide comprehensive cover against risks affecting payment and pay out when default occurs for any reason. Like PRI, CRGs are well understood by markets and relatively easily valued. CRG products offered by IFIs have been few so far, but they have been introduced recently, and are being promoted in domestic capital markets. Various constraints hold them back.

Table 4.1. **Insurance for Debt or Equity? IFI Schemes Compared**

	Debt	Equity
<i>Political; contractual and regulatory</i>		
IBRD Partial Risk Guarantee	X	
MIGA political; breach of contract	X	X
ASDB PRG (public sector)	X	
IADB PRG (private sector)	X	
IsDB export credit insurance	X	
IsDB bank master insurance	X	
IsDB foreign investment insurance	X	X
<i>Contractual only</i>		
AfDB (public sector)	X	

N.B. credit risk insurance only applies to debt.

Source: PricewaterhouseCoopers, 2003.

There have been a limited number of bankable projects, especially in the water sector. Moreover, the guarantor agency has to feel secure with the local financial institution or trust that is being guaranteed, and this also limits the scope of CRGs to countries with better capital markets. CRGs require a full commercial risk evaluation of the borrower, which adds to appraisal costs, and which not all agencies are equipped to perform. Agencies like IFC, dedicated to private sector operations, are better placed than others in this respect.

Finally, *foreign exchange risk instruments* are also in high potential demand. In recent years the impact of brutal currency devaluations on the local cost of servicing foreign currency debt has loomed large in the concerns of foreign investors. Once again, major water projects have been particularly affected. Tariff adjustment formulae agreed with regulators and enshrined in contracts have been overridden by the sheer size of devaluations.

There is effectively no market for affordable coverage of foreign currency risk, and no question that there would be demand for a feasible and affordable product. As Chapter 2 noted, the Camdessus Report outlined a possible liquidity support scheme, which is under study, and OPIC has a pilot instrument. However, as a general solution to this problem in the foreseeable future other methods of mitigating foreign exchange risk, specifically the development of guarantees for local currency debt, may be more promising avenues.

Different Development Contexts

It is sometimes argued that guarantees are only appropriate for countries (or institutions) that have reached a certain level of economic maturity. How relevant are they to poorer countries in regions such as sub-Saharan Africa? How can poorer countries create the conditions to optimise their use?

This section will examine:

- ◆ evidence on the use of guarantees in countries with different levels of credit rating;
- ◆ factors determining the take-up of guarantees;
- ◆ the creation of an “enabling environment” for the use of guarantees.

Relevance of Credit Rating

The only systematic breakdown of the take-up of guarantees by countries at different credit ratings¹⁷ is that done for IFI guarantees for infrastructure in 2001-3 (PricewaterhouseCoopers, 2003). The results, shown in Table 4.2, indicate the importance of distinguishing the three main types of guarantee, which have different user profiles.

For political and regulatory/contractual risk, the IFIs gave no guarantees to investment grade countries during the period concerned. The products issued were bunched in the ratings categories just below investment grade (B- to BB+ on the S&P scale) and again in the non-rated category. While the latter result is somewhat puzzling, the former is consistent with the view that guarantees have their greatest impact on countries on the margins of creditworthiness.

The picture is different for credit risk products. Although few were issued at the time of the survey, there is a clear concentration in the two highest categories of credit rating. An updated account of IFC's products for the longer period 2000–September 2004 indicates that, of a total of \$1 531 million of guarantees issued, only 210 were in sub-Saharan Africa, and virtually all of this total is accounted for by three projects, in South Africa, Nigeria, and a regional scheme¹⁸.

Table 4.2. **Infrastructure Guarantees Issued by IFIs, 2001 to mid-2003**
Number of Cases

S&P country rating	Political risk	Contractual/regulatory risk	Credit risk	Total
BBB- or higher (investment grade)	0	0	2	2
B- to BB+	24	9	3	36
CCC+ and lower	3	0	0	3
Non-rated	19	5	1	25
Totals	46	14	6	66

Notes: Data relate to 52 separate guarantees, some of which covered more than one risk category, hence the higher total. The survey data end in mid-2003, thus excluding a number of more recent cases.

Source: PricewaterhouseCoopers (2003).

Comprehensive data are not available for bilateral agency guarantees, though anecdotal evidence is that their schemes are designed to be complementary with those of the IFIs, and focused on poorer countries. For instance, this is a specific aim of the new GuarantCo scheme (Box 2.5). A number of bilateral agency schemes apply to local currency bonds and loans in low-income countries (e.g. Box 2.8), but these tend to be on a very small scale.

Factors Determining Take-up

Earlier in this chapter the relatively low take-up of guarantees was discussed in relation to the way they were viewed and marketed by agencies and perceived by host countries and users. This section takes a broader view of the issue, considering whether take-up might be correlated with a country's level of development. In principle, the relationship could be either way: if risks were higher in poorer countries, that is where guarantees would flow; on the other hand, the suppliers of guarantees might be more comfortable offering guarantees in countries at higher levels of development. Expressed in this way, the argument could revolve around whether demand or supply factors predominate in the use of guarantees. However, guarantees are not homogeneous, and the different types respond to different factors.

There is no clear correlation between take-up of *political risk insurance* (PRI) and levels of development. Provided issuers continue to be willing to provide cover, the demand appears to be strong amongst lenders and investors

in the poorer countries. Insofar as level of development is inversely related to credit rating, Table 4.2 supports the above view. However, if PRI is routinely sought by banks and investors irrespective of country-specific factors, then the use of PRI will be driven by the volume of international capital flows, which are overwhelmingly towards the less poor developing countries. From 1995 to 2003 sub-Saharan Africa received less than 6 per cent of such flows (Jordan, 2004).

The situation is different for *regulatory and contractual risk*. In principle, this is likely to be more problematic in countries at earlier stages of economic, financial and institutional development, where regulation and legal infrastructure are less reliable. However, we would expect the need for this type of cover to be highly correlated with investment in PSP projects, which happens to have gone mainly into middle-income countries. During the period 1990-2001, sub-Saharan Africa accounted for only 7 per cent of all infrastructure projects with private participation, and many of these were in the telecommunications sector (World Bank/PPIAF, 2003a).

Credit risk is affected by the sponsor, project features, financing structure, and sector-specific factors that cannot be satisfactorily predicted (or “explained”, in the econometric sense) solely by level of development.

In seeking to understand the geographical pattern of distribution of guarantees, certain broad conclusions can be drawn. Guarantees can be relevant to countries at all levels of economic development. Both supply and demand factors explain their pattern of use, and may pull in opposite directions, but demand usually predominates. Guarantees follow the gravitational pull of international capital flows, and also respond to the regional concentrations of PSP projects.

Guarantees give comfort to many such investments and may be clinching factors in a number of them. However, guarantees cannot compensate for the absence of certain *fundamentals* which drive investment, lending and borrowing. These include market size, natural resource endowment, the presence of bankable projects and good sponsors, essential infrastructure, adequate institutions, financial and legal systems including sound banks, lively sub-sovereign entities, the presence of local savings seeking safe outlets, etc. Many of these fundamental factors are related to the level of economic development, and insofar as this applies, the distribution of guarantees *will* be correlated with the level of development.

Creating the Enabling Environment

This study has argued that the basic purpose of guarantees is to reduce the risks faced by lenders, equity investors and operators in developing countries, but that they cannot substitute for the absence of “fundamentals” in markets and institutions. Rather, they can “go with the flow” where other positive conditions are present, and can provide a crucial contribution where the circumstances are right. Ideally, they will spark innovations in local capital markets that lead to permanent improvements through a “ratchet” effect. Maximising the impact of guarantees depends on spotting situations where conditions are approaching a critical state, where the injection of a guarantee will spark a positive reaction (e.g. countries or sub-sovereign entities on the margin of investment grade rating, where reforms are taking place).

Guarantees will have a greater impact in the presence of certain favourable conditions, and there will be more opportunities for the successful use of guarantees where these conditions can be created. These conditions are well known: a good system of commercial law; respect for the law and effective enforcement of it; effective macroeconomic management; clear policies on foreign investment and the role of the private sector; consistent and objective regulation; a good banking system, etc.

In the development of infrastructure such as water, the status, powers and resources of sub-sovereign bodies is crucial. Their responsibilities and relationship with central government have to be clear and consistent. There needs to be the potential for developing a local capital market in which loans are available from local banks. This presupposes the presence of a sound and solvent banking system able to offer a safe outlet for local savings. Many countries fall short on this elementary criterion.

Finally, it is interesting to record the experience of EBRD which has used its influence and leverage to create the comfort and security for sub-sovereign financing without the use of formal guarantees. EBRD has made corporate loans directly to water providers in Riga (Latvia), Kaunas (Lithuania), Bydgoszcz and Krakow (Poland), Brno (Czech Republic) and elsewhere without seeking either sovereign or municipal guarantees. Instead, the Bank negotiates Municipal Support Agreements between the municipality and the water utility under which the municipality undertakes to avoid any action that would interfere with the utility’s ability to comply with the covenants (e.g. on tariffs) that it has signed with the Bank. Although the Bank’s primary motive is to reduce the credit risk on its own loans, the existence of the MSA creates an umbrella under which other lenders can operate.

Magnifying the Impact of Guarantees

There is no reason to believe that the current, relatively modest, level of usage of guarantees is at an optimal or equilibrium level. Changes in institutional arrangements and policies could release greater supply as well as demand. This chapter ends with a brief menu of suggestions, drawing on earlier discussions.

Changing Rules on IFI Capital Provisioning

IFIs should be encouraged to set an appropriate level of capital provisioning for their guarantees, based on a realistic judgement of their risk and likely call on future reserves. In the same spirit, guarantees should not be included in country borrowing limits at their full face value.

Recording of Guarantees in DAC Aid Statistics

Donor agencies would be more sympathetic to expanding their use of guarantees if their programmes could receive better recognition amongst their peer group, starting with their inclusion, in an appropriate form, in aid reporting to the OECD's DAC.

Co-operation between Public and Private Insurers

There may be room for more co-operation between public and private insurers. Possibilities include the creation of aid-funded reinsurance pools for specific regions, pressing bilateral official insurers to untie insurance to make it available for national local banks, promoting political risk insurance by developing countries' own official insurers, the use of reinsurance and "syndications" in specific projects (e.g. in Costanera Norte toll road in Chile), etc.¹⁹.

More Local Currency Guarantees

The development of more schemes by IFIs and donor agencies for providing local currency guarantees is going to be crucial for tapping local savings markets for development financing. This is also the surest way of avoiding foreign exchange risk.

Promoting First -time Market Entrants

The surest impact on capital market development is likely to be from promoting schemes that expose participants to markets (e.g. enhancement of bonds to investment grade, targeting first-time market players) rather than using products that shield them from market disciplines.

Extending Range of Guarantee Products

The market for development guarantees is an evolving one, and agencies jostle with other major players for their appropriate market niche. They need to trim and refurbish their products in response to market trends. At present, there would be a great deal of interest in better products for regulation and contractual risk. There also seems to be a good potential demand for local currency guarantees.

Streamlining and More Realistic Pricing of Products

Compared to private companies, agencies are often criticised for their cumbersome and time-consuming procedures (though these are often the result of shareholder and “stakeholder” requirements). With the greater use of these products, and longer experience with claims, agencies should be able to make their offerings more attractive to users and more accurately priced²⁰.

Creation of Specialised Guarantee Agency?

One solution that is sometimes discussed is whether a specialised, dedicated guarantees agency should be created, to do for credit, regulatory and contractual risks what MIGA now does for political risks²¹. The pros and cons of this option are finely balanced. The advantages of such an agency would be that it would overcome the tension between guarantees and direct loans within a single agency, and the tendency within agencies of treating guarantees as “second class citizens”. This hypothetical agency, with its sole purpose of promoting guarantees, would have no distractions in its single-minded pursuit of this aim.

One disadvantage of this solution would be the loss of synergies from operating within a larger, multiproduct development agency. Offering guarantees as one product amongst others within a lending agency permits officers to draw on a broad pool of development expertise and existing experience. (IFC claims, for instance, that its guarantee proposals are subject to the same kind of full appraisal as its loans). Synergy also has financial benefits in the shape of a large and steady cash flow from loan repayments, which maintains the agency in sufficient financial standing, and provides adequate cash flow for administrative overheads. Lending muscle also gives the agency leverage over host governments in situations where guarantees are at risk of being called.

Notes

1. The benefit of guarantees is not of course restricted to PSP projects; they can equally assist capital raising by municipalities, parastatals, microenterprises, etc.
2. These and others are discussed more fully in Panayotou (1993).
3. Still prevalent in a number of countries.
4. There is still controversy on this matter, For a contrary view, see Arestis *et al.* (2004).
5. Banco Nacional de Obras y Servicios.
6. Sociedad de Inversion Especializada de Fondos para el Retiro.
7. An arrangement whereby the central government undertakes to draw on its fiscal transfer to a local authority to repay a creditor, if the local government defaults.
8. This information was supplied by Protego, Financial Adviser to the Tlalnepantla project
9. Presentation by Hari Sankaran to Camdessus Panel, April 2002.
10. Keynote Address by Venkaiah Naidu to World Bank Water Forum, May 2002.
11. Placing cash flow from specific revenue items into an account managed independently and devoted solely to debt repayments.
12. This section is based on presentations to the Camdessus Panel in November 2002 by Rt Hon Ronnie Kasrils, Rt Hon Trevor Manuel and Mike Muller.
13. Municipalities are barred from borrowing abroad.
14. Presentations by Roland Hunter and Dirkje du-Pont-Bouma to IADF Conference on Financing Municipalities and sub-National Governments, Washington DC, September 2004.
15. IFC and AFD data.

16. Fungibility is a standard objection to project appraisal. It is argued that appraising project A is pointless if the borrower intended to proceed with this anyway from its own resources, which releases the proceeds of the aid or loan to another project, B, which is not the subject of appraisal.
17. Credit rating is not always a good indicator of level of development.
18. IFC data. The total for 2000 was insignificant, reflecting the recent introduction and subsequent build-up of these products.
19. Some of these ideas are suggested by Jordan (2004).
20. Although some agencies are accused of under-pricing their guarantees, others encounter the opposite criticism from users!
21. Although MIGA has operational autonomy it is a member of the World Bank group of agencies. MIGA also offers breach of contract cover.

Chapter 5

Conclusions, Questions and Loose Ends

Although guarantees are familiar items in specialised financial literature they appear only rarely in mainstream development writing. Many non-specialists find guarantees arcane and difficult to grasp. Some of the products are recent offerings, with little experience to go on. They are small relative to conventional development flows, though there is no reliable and accurate estimate of their size. For most development agencies guarantees are a minor component of their portfolios.

This study has outlined the case for guarantees and their purpose, the main types on offer, and examples of how they are being used in different circumstances. It has suggested some of the issues involved in analysing their scope as development instruments and their actual impact on development. This final chapter recaps some possible conclusions, and raises some of the questions and unresolved issues that remain for further discussion and research.

Meaning of “Development Guarantees”

The subject matter of this study has been insurance and guarantees against political, contractual, regulatory and credit risk¹ offered by *international* (multilateral and bilateral) public agencies. Their defining characteristic is having a development, rather than a commercial, motive, which excluded the major category of export credit and investment insurance that is limited to firms domiciled in the country offering the guarantee. There is a large and active private market offering insurance against political, contractual and credit

risks. Because of its commercial nature this was also outside the subject matter of the study, except for purposes of comparison. Nor did the study consider *sovereign* guarantees offered by *national* governments to their own citizens, companies or sub-sovereign bodies when they borrow or attract direct investment.

Attention was drawn to instruments with a *quasi-guarantee* status, such as the “umbrellas of comfort” which IFIs and other agencies erect over other lenders and investors through participations (“B loans”) and Municipal Support Agreements.

There is a grey area between extended term official bilateral investment insurance and development guarantees, which may repay further study. Likewise for the interface between the private and “development” insurance markets.

Changing Motives

In the past, a principal motive for offering guarantees was to promote and sustain international capital flows, and, particularly since the 1990s, support projects involving private participation. This is obviously still an important aim, and has acquired added urgency with the downturn in such flows since the late 1990s and the current shortage of interest in major power and water concessions. Project finance for infrastructure has drastically shrunk.

However, a growing aim of the guarantee programmes of the IFIs, which has been echoed by recent initiatives of the bilateral agencies, is the promotion of local capital markets as safe outlets for local savings and sources of longer-term capital for local businesses, microenterprises and other purposes. Allied to this is a resurgence of interest in financing options for sub-sovereign bodies such as municipalities and utilities, a particular concern in the water sector.

There is a perception in some quarters that guarantees exist to promote *private* investors and operators, and *international* rather than national finance. This is mistaken, since there is a spectrum of private and public actors on both lending/investing and borrowing/host sides involved in the use of guarantees. Although political risk insurance is mainly used for *international* finance, other types of guarantees are being used to promote better access of *local* public agencies to *local* credit and investment markets.

Measurement Problems

One obvious reason for the obscurity of guarantees is the lack of comprehensive statistical compilation. The OECD's DAC does not collect data on guarantees from its Member States as part of its aid reporting task. Practically the first attempt to assemble comprehensive data was undertaken by the World Bank in 2003 in response to the Camdessus Panel report, but this was a one-off exercise limited to products offered by the IFIs.

This lack of transparency reflects real methodological problems which are under discussion in the DAC Working Party on Statistics. Guarantees and insurance policies are supposed to be priced on actuarial principles to reflect the probable cost of future compensation payments. Only if there is a minimum subsidy can this be reported as ODA. In the absence of much experience of running the schemes concerned, and the few cases of paying out, the real cost of the contingent liability involved in giving a guarantee is difficult to estimate, and the DAC has yet to agree on reporting conventions². The water is further muddied by the reluctance of policyholders to claim against IFIs and donors because of the potentially wider repercussions on their credit standing and relations with major financial agencies.

Relative Size

The face value of guarantees issued is small in comparison with any of the conventional flows recorded by DAC. In the last few years guarantees issued by the IFIs have been equivalent to c. 9 per cent of their combined programmes, but they make up less than 1 per cent of bilateral aid. These face values take no account of the effect of a successful guarantee in leveraging a larger volume of finance from other parties, though this is hard to substantiate in strict cause and effect terms. In principle such leveraging could be important for private direct investment, concessions, bond issues and commercial bank loans.

It would be unjust to reckon guarantees solely on their face value, since they are instruments that deliberately set out to have a catalytic (or *demonstration*) effect on the parties they apply to and the markets they operate in. There is value in further research on actual cases, where a sufficient period has elapsed to judge these catalytic effects.

Constraints on their Wider Use

There is no obvious constraint on the uptake of political risk insurance, where there is a large, long-established and active market involving both private and public sector players. The situation is different for other product types. Guarantees against contractual and regulatory risk, including breach of contract policies, are supply-constrained, though there is a large potential demand. They are time-consuming to draw up and in the event of default often involve drawn-out procedures to recover payment. Partial Credit Guarantees have also had a slow take-up, partly owing to attitudes and policies in the supplying agencies, and partly to the preferences of recipient governments for direct loans. There are no effective guarantees against exchange rate risk.

To a large degree, guarantees respond (as well as contribute) to the gravitational pull of international capital and direct investment flows, which obey *fundamentals* such as market size, local promoters, potential growth, the presence of adequate infrastructure and supporting services, etc. Agencies report a shortage of demand for recently introduced guarantees and a paucity of suitable projects. This constraint is likely to be especially acute for the various bilateral initiatives being mounted, aimed at the poorer countries.

Market Niche, or Unfair Competition?

Political risk insurance (PRI) has been on offer from official bilateral export promotion agencies for many decades, and in the early 1990s growing numbers of private insurers entered this market. MIGA, the main developmental supplier of PRI, entered the fray at a similar time, staking out its niche in terms of tenor (length) of cover, reputation, and relationships with host governments. Private insurers retain a comparative advantage in the range of risks covered, their flexibility of product design, speed of processing, etc. Private insurers also have a higher proportion of their exposure in high risk countries, especially Latin American. Some private insurers avoid PRI because of what they characterise as uneconomic competition from the official insurers.

Private insurance companies have also been active in credit risk cover since the 1970s and offer serious competition to the agencies. The monoline insurance companies offer integrated risk management products, including

full credit risk cover. The agencies, of which the largest supplier is IFC, only offer partial risk cover, and insist on the same level of credit and due diligence scrutiny of proposals as for a direct loan. Uptake of their credit risk guarantees has been rather slow, possibly because the private market can offer full coverage and more rapid and streamlined procedures, though at a price. The bilateral agencies offering PCGs and risk-sharing schemes have tended to concentrate on smaller projects in low-income countries, where head-on competition with private insurers is less.

All the development agencies, with the possible exception of MIGA, have entered this market quite recently and have short experience of claims. In these circumstances, pricing of the guarantee product is difficult, and all official agencies, with sovereign status and – in some cases – access to grant funds, face accusations of under-pricing and subsidy. IFIs, whose funds are raised in financial markets, and which have a mandate to cover their costs and act in a commercial manner, are less likely to under-price their guarantees, and indeed often report fee-resistance on the part of their clients. The more general point is that, where active markets are absent or of recent origin, what is a “market-related” charge is open to debate.

Comfort, Prop or Stimulus?

It is reported that banks take out political risk insurance as a matter of course, whatever the circumstances, as an extra reinsurance and in order to avoid penal capital provisioning requirements. Where this is true, PRI acts as a *comfort*. In other cases, a foreign company, having surveyed the prospects for investment or operation, may decide that the weak link is regulatory risk. Taking out regulatory risk guarantees will provide the missing *prop* which is decisive for the implementation of the project. A third situation is where a Partial Credit Guarantee lifts the borrower’s credit rating above a critical threshold, at which access to the market is possible. This lowers the cost of borrowing or improves the tenor sufficiently to create a new asset class and enable the local capital market to expand. Such a guarantee acts as a *stimulus*.

Some guarantees are clearly redundant, in the sense that the activity they guarantee would proceed without them. Others spark innovation in capital markets, which are never the same again, or give borrowers a credit standing from which platform they never look back. The main rationale for the involvement of development agencies in activities for which there is an existing

private market must be to make a difference. There is a good case for carrying out evaluation studies of established projects involving the use of guarantees in order to test the claims of their promoters. Such studies would provide evidence on the circumstances in which guarantees lead to permanent (*sustainable*) financial innovation, rather than a one-off effect.

Granted that all guarantees aim to reduce risk, a distinction can be made between those that shelter participants from, and those that expose them to, market forces and disciplines. A 100 per cent credit risk cover, although it comes at a price, is likely to reduce the effort a lender puts into investigating the status and prospects of the borrower. On the other hand, a guarantee that raises borrowers' credit standing to the point where they enter the local market for the first time exposes them to market forces in a healthy way. The intervention of outside agencies into a local financial market may introduce a bracing "wind of change", to the discomfort of an existing banking cartel.

The Power of the Credit Ratings Agency

All those familiar with the workings of financial markets will need no reminding of the great power, influence, and responsibility of the international ratings agencies, exemplified by the Big Three: Standard and Poor's, Moody's and Fitch. These agencies sit in regular judgement on the financial status and prospects of central governments, municipalities, other sub-sovereign institutions, and banks and companies of all kinds. Upgrades or downgrades in a credit rating can mean a significant reduction or increase in the cost of raising funds, or the difference between being able to borrow or not. The crucial threshold is "investment grade" rating, which is worked out on different criteria, depending on whether local or foreign finance is involved. Institutions with a rating below investment grade will be debarred from tapping into a range of savings pools, such as pension funds, or will have to borrow at excessive cost (e.g. through *junk bonds*).

Guarantees will normally have their most tangible effect on the credit rating of the borrower or investing company, raising them by several notches on the scale used by the agency concerned. This will enable the company, bank, etc. to raise money on more favourable terms.

Clearly, the credit ratings agencies have an enormous influence on development financing, yet their operations are little understood amongst the development community. What methodologies are used to establish credit ratings? How do the Big Three differ? Is there any second guessing of each others' results? Should other financial institutions carry out their own independent assessments (some IFIs do)?

Distortions or Correctives?

Guarantees distort markets, often quite dramatically, such as doubling loan tenors or halving interest rates, compared to the "before project" scenario. In their defence, they can claim to correct existing market distortions, such as those arising from *financial repression* and dysfunctional banking systems caused by state intervention. They may also compensate for the failure of markets to value important externalities such as environmental and public health benefits (e.g. from investments in water and sanitation).

Describing an effect as a "distortion" implies that some ideal state exists as a blueprint for action. Neither experience to date nor the development finance literature has converged unambiguously on such a fortunate state. The paradigm of financial repression is considered by many to be an oversimplified, though not necessarily invalid, guide to reforming capital markets. There is much to be said for pragmatism, correcting what is clearly not working and being suspicious of grand designs (the best may be the enemy of the good). Guarantees are a useful part of the pragmatic policymaker's toolkit.

Relevance to Poorer Countries

Guarantees are potentially useful in countries at all levels of economic development where risk is a deterrent to lending or investment. The main types of guarantee – political, regulatory/contractual and credit – have different patterns of distribution, not surprisingly in view of their distinct purposes. The pattern of guarantees responds to both supply and demand factors but

demand probably predominates. Their take-up is influenced by flows of international capital and direct investment, which are attracted mainly to Lower Middle and Upper Middle developing countries, in the World Bank's terminology. They are also associated with concentrations of projects with private participation, which follow a similar regional bias.

The guarantee programmes being developed by bilateral agencies are designed to counteract this pattern, by focussing on opportunities in the Low Income countries, and the development of local capital markets. Some of the IFI projects will have the same effect, insofar as they aim to develop local currency transactions amongst parties who currently have a poor credit rating.

Local Currency Guarantees – the Way Forward?

The encouragement of local sources of finance is an obvious and practical solution to devaluation risk, which is probably the major single obstacle to international lending and equity investment in emerging and poorer markets. Apart from making project finance more secure, this helps local capital markets to grow and diversify. Local sources of savings, which are potentially very plentiful in many emerging markets, can be harnessed for local investments rather than go overseas, into local government bonds, or into property speculation. The precondition of attracting pension funds and other savings deposits into local outlets is the availability of investment-grade paper. Guarantees and other forms of credit enhancement can raise local borrowers and bond issuers over the critical threshold.

Both the IFIs and bilateral donor agencies have started offering local currency guarantees. In some ways bilateral agencies have a comparative advantage over the IFIs in this area, since they can contemplate *attrition* in their funds in a way that the IFIs, with their different mandates, cannot. This also enables the bilaterals to market their products in the poorer countries, as noted above.

In a number of emerging markets international agencies have been drawn into the offer of guarantees to fill a vacuum caused by the suspension of – or tight constraints applied to – national government guarantees. This is often the result of a policy of decentralisation of responsibility for public services, including financial provision. But it also results from macroeconomic debt problems which forces central governments to limit their contingent liabilities.

In such cases, the international guarantees substitute for former national ones. Additionality may be an issue and, where it is, the value-added of the international guarantee needs to be established.

Opportunities for Leverage

Guarantees are most successful where they have a catalytic effect, supplying the final ingredient necessary to produce a critical reaction. This study has identified cases where they have caused innovations in capital markets leading to a chain reaction from existing institutions. Spotting such potential near-critical situations requires experienced judgement and a degree of imagination on the part of the agencies concerned. For example, countries or institutions that are at or just below creditworthiness are likely to be promising candidates for the use of guarantees.

For the guarantee to be effective, and to produce a sustainable effect, other conditions have to be present. Maximising the potential effect of guarantees depends on creating an Enabling Environment – such familiar *desiderata* as a sound legal system, law enforcement, a solvent banking system, honest administration, a stable macroeconomic situation, sufficient autonomy for sub-sovereign institutions, political interest and support, transparency in financial dealings, the presence of credit ratings agencies, etc.

*To end on a cliché, guarantees can only go with the flow
and cannot swim against the tide.*

Notes

1. The study also discusses exchange rate risk, but concludes that insurance against this is currently not a practical proposition, though pilot testing of a possible scheme is under way.
2. Initial payments to set up guarantee schemes, and payouts when guarantees are called, can be reported as ODA under current rules.

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